SENATE COMMITTEE ON BANKING, FINANCE and INSURANCE

SENATOR MICHAEL J. MACHADO, Chair

PRESERVING THE AMERICAN DREAM: Homeownership Preservation and the Subprime Mortgage Crisis

September 2007

FINAL REPORT

Committee Members:
Senator George Runner, Vice Chair
Senator Lou Correa
Senator Dave Cox
Senator Dean Florez
Senator Dennis Hollingsworth
Senator Alan Lowenthal
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Preserving the American Dream:

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Final Report

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STAFF SUMMARY REPORT

INTRODUCTION

The Senate Banking, Finance & Insurance Committee held its third informational hearing on mortgage lending during 2007 on Tuesday, August 21, 2007. The hearing was titled, "Preserving the American Dream: Homeownership Preservation and the Subprime Mortgage Crisis." Chairman Michael J. Machado convened the hearing at 9:30 AM, recessed it at 11:00 AM for Senate Floor Session, reconvened the hearing at 1:25 PM, and adjourned it at 4:45 PM. The hearing was held in Room 112 of the State Capitol. During the course of the hearing, the Committee heard from 18 invited witnesses and five members of the public. The hearing attracted approximately 75 attendees.

Eight Committee members attended the hearing, as well as the Chair of the Assembly Banking & Finance Committee. Members attending the hearing included:

Senator Michael Machado, Chair
Senator George Runner, Vice Chair
Senator Lou Correa
Senator Dave Cox
Senator Dave Hollingsworth
Senator Bob Margett
Senator Gloria Romero
Senator Pat Wiggins
Assemblymember Ted Lieu

As described by Chairman Machado in his opening remarks, the hearing was intended to focus on borrowers who obtained adjustable rate mortgage loans during 2005 and 2006, a period during which many lenders loosened underwriting standards on subprime loans. Many of these borrowers are facing interest rate resets on their loans in 2007 or 2008, and may face foreclosure if they are unable to sell their homes, refinance their mortgages, or work with the company who services their mortgage loan to restructure their loan terms. The hearing was designed to examine the economic implications of increasing defaults and foreclosures; identify barriers that may hamper the ability of lenders and servicers to restructure securitized loans; examine what lenders, servicers, counseling organizations, and federal and state regulators are doing to help keep people in their homes when their mortgages become unaffordable; and hear from consumer advocacy groups about what more industry and government should be doing to preserve homeownership among vulnerable borrowers.

This report contains the staff summary of the hearing (Section one), reprints the hearing agenda and the background paper (Section two), and reproduces the written material provided by hearing witnesses (Section three). Individuals desiring a DVD copy of the hearing may purchase one from the Senate Television and Video Program Office at (916) 651-1531. Written copies of this final paper are available at no charge from the Committee in Room 407 of the State Capitol or by phoning (916) 651-4102.

KEY FINDINGS

During the course of the hearing, the Committee heard consensus from witnesses on two general points, but a great deal of disagreement on the finer aspects of these points and on other issues. Many of the views discussed immediately below were expanded upon in witness testimony, a summary of which is provided in the section following this one.

Foreclosure As A Last Result

One topic of unanimous agreement was that foreclosure should be avoided, if at all possible, because it is almost always the least advantageous option for all parties involved. Borrowers who lose their homes to foreclosure often do not return to the housing market for many years, if at all. Often their credit is so tarnished by the foreclosure that they are unable to recover financially. A reduced supply of homeowners has long-term ripple effects that negatively impact many sectors of the economy reliant on real estate and construction. Neighborhoods in which significant numbers of foreclosures occur experience depressed housing markets that can remain sluggish for many years, which harms homeowners who retain their homes by reducing their housing values. Foreclosure is also a very expensive process for lenders and servicers – as much as three times more expensive than administering a mortgage loan that is current. Lenders and servicers who have high foreclosure rates also face reputational risk. Foreclosure can also be harmful to investors who hold mortgage-backed securities, because of the negative impacts of rising foreclosures on the credit markets.

Indeed, all of the lenders and servicers from whom the Committee received oral or written testimony have instituted a variety of loss mitigation measures and loan modification programs designed to help identify borrowers who are likely to run into trouble making their payments, work with borrowers in trouble to help modify or refinance their loans, and help minimize the possibility that loans will go into foreclosure.

However, all of the counseling organizations from whom the Committee heard described difficulties they had encountered in working cooperatively with lenders and servicers, and all of the consumer advocates at the hearing testified about their dissatisfaction with the extent of lenders' and servicers' efforts in this area. While there is no disagreement among lenders and servicers about the benefits of avoiding foreclosure, the Committee was told that these lenders and servicers are not consistently and uniformly backing up their words with actions.

In hopes of encouraging lenders and servicers to do more to work with at-risk borrowers, Chairman Machado asked the Departments of Financial Institutions (DFI), Corporations (DOC), and Real Estate (DRE) to report back to the Committee on how they can use their bully pulpits to compel their licensees to act responsibly. Specifically, the Chair asked the department to report back to the Committee on what they can do immediately, without initiating the often lengthy regulation process, to urge their licensees to: 1) ensure that loan products are paired with borrowers for whom those loan products are appropriate, and 2) work flexibly and proactively to modify and/or refinance loans that borrowers are having trouble affording. Copies of the department's responses are included in Appendix A.

The Need For Borrowers To Come Forward

There was also uniform agreement on the importance of gaining borrowers' trust and using that trust to encourage borrowers to notify lenders as soon as possible once they realize they may be unable to make their mortgage payments. Yet, many borrowers do not trust their lenders, and while counseling organizations are sometimes more successful at gaining borrower trust, many borrowers are isolated by their unwillingness to share their financial troubles with an outside third party. All of the witnesses agreed that more needs to be done to encourage borrowers to step forward, either to a counseling agency or to the lender who services their loan, but there was no consensus on the best approach. At present, it is unclear whether radio ads, television ads, print media ads, Internet ads, billboards, public service announcements, mail campaigns, phone contact, or some combination of the above is most effective. The lenders, servicers, and counseling organizations who testified all described using one or more of the aforementioned approaches, but did not indicate whether they had experienced more success with one than another.

Compounding the challenges of getting borrowers to come forward are reports that while lenders *say* they want borrowers to come forward before they go into default, counseling organizations find it very difficult to get lenders to work out loan modifications with borrowers who are current on their loans. Once more, what lenders say, and what counselors experience on behalf of their borrower clients, is not in sync.

Reviewing Lenders' and Servicers' Actions

Recognizing the need to determine whether the lending institutions or the counseling organizations are more accurately portraying the current situation, the Chair followed up after the hearing with DFI and DOC. He asked them to report back to the Committee on the extent to which DOC's and DFI's regulatory examinations of lenders and servicers evaluate the number and nature of workout plans and refinancings these institutions are entering into with borrowers who are having affordability problems in their current loans. The Chair expressed a desire to investigate whether the institutions are working proactively and cooperatively with borrowers, the extent to which they are treating similarly situated borrowers similarly, and the extent to which they are being consistent over time in their decisions to engage in workouts or refinancings or to foreclose on homes. In following up with DFI and DOC, the Chair was echoing the concerns of the California Reinvestment Coalition and Center for Responsible Lending for more transparency and accountability among lenders and servicers. Appendix A contains DFI's and DOC's responses.

Funding and Availability of Non-Profit Counseling Organizations

Several of the representatives who testified on behalf of counseling organizations and consumer advocacy groups spoke of the need for more funding for both national and local, U.S. Housing and Urban Development (HUD)-approved counselors. Several of the lenders testified that they were supporting both national and local counseling efforts. However, it is clear that whatever money is being contributed by private industry is insufficient to help the significant numbers of people who need help. When done properly, counseling is both time-consuming and expensive, and there is simply not enough money available to fund counseling for all of those who could benefit from it.

The maze of counseling organizations and the complicated ways in which these organizations are funded no doubt also complicates efforts to help at-risk borrowers. For example, NeighborWorks America is supported primarily by funding from Congress ($117 million during federal fiscal year 2007). However, the NeighborWorks Center for Foreclosure Solutions is funded through private, external partners, such as lenders, Fannie Mae, Freddie Mac (together, the government-sponsored enterprises, or GSEs), the Housing Policy Council, and an insurance company. The HOPE hotline was created by the Homeownership Preservation Foundation, which is privately funded by lenders and Fannie Mae. However, the Homeownership Preservation Foundation jointly runs the HOPE hotline with NeighborWorks America (publicly funded) and five local nonprofit credit counseling partners, which receive both public and private financing. What percentage of the funding available for HUD-approved counselors comes from public sources versus private sources? We don't know. How much money has each lender and servicer contributed toward national and local counseling organizations? That is also unclear. In the context of this uncertainty, it becomes especially difficult to evaluate claims that certain entities "aren't doing enough."

There is no question that nonprofit credit counseling organizations require more funding to provide services to the growing number of borrowers in need. The key questions are who will provide that funding and how a borrower facing the uncertainty of losing their home can *easily* find a housing counselor near them. Outreach seems to be the key, but there seems to be little agreement on the best ways in which to conduct this outreach and on the sources of funding to pay for it.

The Roles of Government and Private Industry

There was no consensus among hearing witnesses about who (the state, the federal government, or private industry) should take the lead in funding efforts to help stem the tide of rising foreclosures, nor who should play secondary roles. Those who represent borrowers' interests urged the Committee and the Legislature to act with a sense of urgency. They seem less concerned about where funding originates and more concerned that money is made immediately available.

STAFF SUMMARY OF WITNESS TESTIMONY

The summaries that follow were developed by staff using a DVD of the hearing, which, as noted above, is available for purchase from the Senate Television and Video Program Office. Readers are also directed to the written testimony that appears in Section 3 of this report.

Welcoming Remarks from Chairman Machado

The Chair began the hearing at 9:30 AM by thanking everyone for attending, and advising the participants that the hearing would be a bit disjointed, because Senate Session had been called for 11:00 AM. The Chair expressed his desire to get through as much of the agenda as he could before recessing for Senate Floor Session, and to reconvene the informational hearing upon adjournment of Session. He offered to accommodate witnesses who had to leave by noon, when the hearing had originally been scheduled to adjourn.

In his opening remarks, the Chair sounded a note of urgency, noting that over $1 trillion in mortgages will have their interest rates reset during 2007 and 2008, and reminding hearing attendees that the peak month for interest resets will be this October, when over $50 billion in loans will see low monthly payments increase significantly. He explained that the hearing was designed to give the Committee a better understanding of how industry is responding to borrowers and what barriers hamper their flexibility to engage in loan workouts with borrowers having trouble making their mortgage payments.

Chairman Machado believes that current disarray in the mortgage and secondary investor markets poses both a narrow and near-term impact on lenders, investors, and borrowers, and a broader and longer-term impact on the general economy. In the short-term, lenders and investors are concerned about the quality of their portfolios and how to minimize the decline in market value of those portfolios due to deterioration in the value of the underlying collateral and the availability of liquidity. Borrowers face losing their homes and ruining their credit.

The long-term effect of foreclosures is very broad. When a lender forecloses on a homeowner, foreclosure becomes an impediment to that homeowner getting back into the market. Fewer home buyers have a broader effect on housing values, retail sales, property values, and local and state tax revenues. Concentrations of foreclosures can fundamentally change neighborhoods and communities for the worse.

Chairman Machado concluded his opening remarks by stating that legislative efforts to intervene in the market are not the answer. The short- and long-term impacts of foreclosure should put lenders and the marketplace on notice that they have a responsibility to step in and help people remain in their homes. In an up market, subprime lending provided opportunities for homeownership to those who might not otherwise have been able to enter the housing market. With the recent market restructuring and corrections, we all have a responsibility to see how we can keep the American Dream alive while maintaining reasonableness in the marketplace and meeting the expectations of investors.

Economic Impacts of Rising Foreclosures: When people lose their homes to foreclosure, who else gets hurt?

Allen Prohofsky, Senior Economist, and **Dave Vasche**, Director of Economics, Taxation, and Fiscal Forecasting at the Legislative Analyst's Office (LAO) walked the Committee through a six-page handout that is reproduced in Section 3. In its presentation, the LAO noted that financial markets are still in flux, and it is unclear exactly what types of adjustments will occur over the weeks and months to come. Because the housing market slowdown has been apparent for several months, both the LAO and the Department of Finance incorporated a slowdown in the housing sector in their most recent state economic and revenue forecasts. There is some evidence suggesting that the housing slowdown may be greater than previously thought, and that the troubles in the mortgage market may affect other segments of the financial markets and the economy. However, many other sectors of the economy remain fairly strong and, so far, have picked up the slack caused by housing market troubles. Overall, the full implications of the mortgage market's problems, both nationally and in California, are still unfolding and will not be known for some time. There is unfortunately no formula that one can use to directly relate the existing market turmoil to gross state product or to state revenues. The LAO concluded by noting that while the current turmoil in the mortgage market is producing a drag on the economy in the short-run, most economists believe that these types of corrections are necessary for the long-run health of the economy.

Barriers to Home Loan Restructuring: What barriers exist, and what steps are being taken to remove them?

George Miller, Executive Director of the American Securitization Forum (ASF), described his organization as a not-for-profit industry association representing approximately 370 professional firms involved in one or more aspects of securitization. ASF's roles include building consensus among industry participants about matters of importance to the securitization industry, advocating the securitization industry's views on important issues, and serving as a source of market-based information and education. Mr. Miller testified in this lattermost role.

Mr. Miller described securitization as a large and important means of financing business activity, a mechanism for providing capital, and a form of asset-based pricing. Historically, mortgages were owned by banks. With the advent of mortgage-backed securities (MBSs), mortgages now have new owners – investors. Most investors in MBSs are typically institutional investors, such as banks, insurance companies, money managers, and hedge funds. Referring to the chart of a typical transaction structure that he provided the Committee (see Section 3), Mr. Miller urged the Committee to envision a solid line drawn horizontally across the chart, separating the originator, mortgagors, and master servicer (above the line) from the sponsor, depositor, underwriter, issuing entity, trustee and supplemental interest trust trustee, and investors below the line. The traditional lender/borrower relationship is represented by the entities above the line, while the securitization relationships are illustrated by the entities below the line.

In response to a question from the Chair, Mr. Miller stated that the role of a loan servicer is not materially different under the old lender/borrower model and the new securitization model. In both situations, the servicer is required to service the loan according to its terms and maximize both the cash flow from and the recovery value of the loan and its underlying collateral.

Mr. Miller then walked the Committee through his organization's Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, which is reproduced in Section 3. He explained that foreclosure is almost always the least preferred alternative for borrowers and investors. He also challenged the assertion that securitization makes it difficult, if not impossible, to modify a loan, and stated that there is significant flexibility to modify loans, notwithstanding securitization. Mr. Miller asserted that only about one-third of subprime securitizations have any limitations at all on a servicer's ability to modify them. Furthermore, while limitations do exist, they occur in a minority of situations, can be overcome, and do not impose a materially significant impact on the ability of a servicer to develop a loan workout. Rarely is there direct involvement required by the investors in order to approve a loan modification.

Mr. Miller cited four main categories of potential barriers to modifying securitized loans, all of which he believes to be surmountable. These barriers are: 1) contractual in nature (i.e., barriers imposed by the terms of the pooling and servicing agreement), 2) regulatory (such as those imposed by the tax code or accounting standards), 3) economic (e.g., whether modifying the loan is feasible or economically desirable), and 4) operational (i.e., are serving organizations equipped to engage in loan workouts).

Questions From Committee Members

The Chair asked whether the accessibility of a servicer to a borrower would be any different for a securitized versus a non-securitized loan, and Mr. Miller responded that accessibility should be the same. However, when asked whether securitization made a difference in the decisionmaking process that a lender goes through in deciding whether to foreclose on a borrower or modify that borrower's loan, Mr. Miller acknowledged that some differences could occur between the decisionmaking process on a securitized versus a non-securitized loan. For a servicer servicing a securitized loan, the key to the foreclosure versus loan modification analysis is which choice will maximize the net present value or the anticipated future recovery value of the asset for the investors. A portfolio lender servicing a loan that it originated could consider certain things that a servicer of securitized loans could not, such as personal relationships with the borrower and non-cash flow issues.

The Chair also asked about the long-term impact of increased foreclosures on the cost-effectiveness of foreclosures – the concept that as lenders foreclose on more and more homes, the more the values of the remaining homes decrease, and the less money that each successive foreclosure yields for the investors. Mr. Miller responded that the net present value analysis required by pooling and servicing agreements is dynamic and takes those factors into account. Each loan modification is evaluated on a case-by-case basis.

The Chair then asked whether servicers were regulated. Mr. Miller responded in the affirmative and cited three forms of regulation – 1) the vast majority of MBSs are registered with the Securities and Exchange Commission (SEC) and available for review by the public; 2) many of the participants in a securitization are overseen by the SEC; and 3) banks and other financial institutions that engaged in servicing activities are all regulated at either the federal or state level.

Looking through ASF's handout (see Section 3), Senator Romero asked Mr. Miller whether there was any contradiction between ASF's Principle 4b, which directs servicers to act in the best interest of the securitization investors in the aggregate, and Principle 4c, which directs servicers to act in the best interest of borrowers. He responded that ASF's principles speak to a balancing of those two interests by all servicers, and that the principles are not contradictory.

Loan Restructuring: What is being done to help keep people from default and foreclosure?

Lender and Servicer Panel

Countrywide Financial Corporation opted not to send a witness to testify but submitted written remarks that are included in Section 3 of this report.

Michaela Albon, Senior Vice President and General Counsel of Home Loans, Washington Mutual (WaMu), led off the lender and servicer panel by stating that she agreed with the Chair's opening remarks. WaMu is the third largest lender in the country as measured by volume and holds both portfolio loans (i.e., loans it originated and still owns) and securitized loans, including thousands of subprime loans. WaMu uses two specific approaches with borrowers who may run into trouble keeping current on their mortgage loans – 1) traditional loss mitigation efforts and 2) more proactive attempts to reach out to customers prior to their getting into trouble. Ms. Albon focused on the second approach in her testimony.

In April 2007, WaMu set aside $2 billion to make new loans or modify existing loans, primarily, but not exclusively, directed at customers who had 2/28s or 3/37s. A staff of 700 administers the initiative. In order to qualify for this program, borrowers must be current on their loans at present; prior delinquencies that have since been corrected do not disqualify the borrower. WaMu has had the most success in working with borrowers when it has reached out and proactively contacted them 180 days prior to their loan resets, but WaMu continues to attempt contact with these borrowers on a monthly basis in the months leading up to the reset. WaMu offers two types of help – 1) it refinances borrowers at discounted rates of up to 50 basis points (half of one percent), and tries, when possible, to put these borrowers into fixed rate loans (this is the option most frequently used for securitized loans) and 2) it modifies loans, as applicable for borrowers' individual situations (the option most frequently used for portfolio loans). Response from borrowers to these outreach efforts has been very good. At peak demand, WaMu was receiving about 600 calls per day inquiring about loan modifications and refinancings.

WaMu's refinancing and loan modification efforts are primarily directed at their subprime customers. When possible, WaMu moves its subprime borrowers into prime loans. WaMu also reaches out to community partners and consumer counselors in its efforts to outreach to customers. Ms. Albon stated that it is much easier to make contact with borrowers who are not in default than with those who are. She did acknowledge that her institution has more flexibility when it deals with loans it originated than with securitizations, but asserted that WaMu does have the ability to work proactively to modify securitized loans.

Ms. Albon concluded by stating that avoiding foreclosure is in the best interest of all parties involved.

Shane Ross, Senior Vice President of Account Management, Litton Loan Servicing, introduced Litton as strictly a mortgage servicer. Litton does not originate loans, as do the other financial institutions invited to testify. Litton services just under 400,000 loans at present, most of which are securitized. Mr. Ross echoed Mr. Miller's comments about the flexibility allowed on securitized loans. He stated that when Litton feels it needs to extend the caps present in pooling and servicing agreements, the rating agencies and bond insurers have been very understanding, and Litton has generally been able to make the needed modifications. He also noted that the FAS 140 (accounting) issue has been successfully resolved and does not present a barrier to loan workouts. According to Mr. Ross, most servicers, including Litton, are modifying securitized loans.

Mr. Ross emphasized that servicers must reach out to borrowers. Unlike WaMu, which reaches out to borrowers for the first time 180 days before their loans reset, Litton has had more success in reaching borrowers 90 days prior to a reset, and, like WaMu, every month thereafter until the reset. The contact is important, to ensure that the borrower fully understands the terms of his or her loan. When they succeed in contacting borrowers, Litton is successful in helping borrowers understand how their payments are likely to change. The biggest challenge Litton faces is making that contact. Despite having tripled its workout department staff and doubling its call center staff, Litton is unable to contact everyone, and many of those it tries to contact are unresponsive.

Mr. Ross echoed Ms. Albon's comments by stating that when a loan becomes delinquent, the servicer's ability to contact the borrower is limited. He also stated that there is no good outcome from a foreclosure. When considering a loan modification, Litton makes the effort to fully understand the details of a borrower's income profile, so that they don't unknowingly put a borrower into a loan on which they will default six months down the line. However, Mr. Ross did acknowledge that, as a servicer bound by a pooling and servicing agreement, Litton must also try to maximize the value of the payments it receives from borrowers (i.e., it walks a fine line between getting as much money from a borrower as it can, while still ensuring that the borrower is in a loan he or she can afford).

Responding to a question from the Chair, Mr. Ross stated that servicers have the responsibility to advance the principal and interest payment to the investor, regardless of whether the borrower makes those payments. Servicers are eventually compensated for these advances from the securitization trust, but there can be some time between the initial advance and the ultimate reimbursement. Mr. Ross also expressed his desire to dispel a common misconception about the way in which servicers are compensated for their up-front costs. Advances made by a servicer are recoverable from the securitization trust at the time of a loan modification, not just upon foreclosure. For this reason, servicers do have an incentive to complete loan modifications; there are no hidden incentives for servicers to foreclose. Referring to Senator Romero's earlier question on the topic, he stated that there is often an alignment between the needs of the customer and the needs of the investor.

Ed Delgado, Senior Vice President, Default Information and Analytics, Wells Fargo, stated that a lot of his comments were already made by the representatives from WaMu and Litton. For that reason, he stated his intent to focus only on the key points he wanted to stress. Lack of contact with the borrower is the key challenge that lenders and servicers must overcome. According to a recently updated study by Freddie Mac, over one half of all loans that advance to foreclosure do so without any contact between the borrower and the lender. Awareness of borrowers that they can and should contact their lenders before they run into trouble is the key to avoiding foreclosure. "We can't apply solutions if we can't contact the borrower."

Wells reaches out to some borrowers six months prior to a rate reset. It has also begun monitoring the credit scores of its borrowers and reaching out to contact borrowers whose credit scores are declining, even if they are current on their loans. This effort is intended to focus on borrowers most at risk of default.

Mr. Delgado also stressed the value of debt counseling to borrowers and noted that Wells is among the industry partners who help fund national borrower assistance hotlines.

Paul O'Leary, Director of Consumer and Mortgage Lending, HSBC Finance Corporation, spoke about three topics – 1) HSBC's approach toward working with customers to avoid foreclosure, 2) the flexibility HSBC offers through it homeownership preservation programs, and 3) ways in which HSBC reaches out to non-delinquent customers to prevent delinquency.

HSBC services over 800,000 mortgage loans across the country. Its portfolio includes a mixture of retail, wholesale, and correspondent-originated customers and both first and second-lien mortgages. HSBC is primarily a portfolio lender – for the most part, it originates and services loans for the purpose of holding them in its portfolio as assets. For that reason, HSBC is not commonly limited by securitization agreements in their ability to modify loans. Mr. Leary stated that his testimony applied to all of HSBC's loans, regardless of whether the loans were originated by or purchased by HSBC.

Like the other lenders and servicers whose representatives addressed the Committee, HSBC works to establish contact with customers experiencing difficulty prior to delinquency and at the early stages of delinquency, in order to discuss options available for each individual situation. Its greatest obstacle in providing solutions is a lack of communication from customers. HSBC uses outbound telephone calls, structured letter campaigns, and the Internet to reach out to customers, and also uses the services of community groups and consumer advocacy organizations to help in its outreach. It is continually analyzing and refining the methods it uses to contact customers, and has surveyed customers on the effectiveness of its outreach programs.

HSBC has had a great deal of success reaching borrowers through third-party community groups, and, as a result, supports a number of national and local programs to encourage this communication channel. Some of HSBC's key collaborative programs are illustrated in a handout Mr. O'Leary provided to the Committee (see Section 3).

In October 2006, HSBC established a new program specifically designed to meet the needs of customers with adjustable rate mortgages. As part of this program HSBC contacts borrowers by letter while their loans are current, and prior to an interest rate reset. It provides information on when the rate will reset, and an estimate of how much the new payment will be. HSBC follows up the letter with a phone call from employees who are trained to educate customers on the details of their loans. If HSBC determines that a customer may have trouble affording their loan after the interest rate reset, they offer the customer the ability to maintain their low introductory rate for an additional 12 months, in order to give the customer time to refinance the loan or improve their financial situation. Customers who are delinquent can have their low introductory rates locked for up to two years, based on their individual circumstances.

HSBC has two other programs to help customers who are experiencing trouble affording their mortgage payments, including a loan restructuring program and a foreclosure avoidance program. The loan restructuring program helps customers who are experiencing short-term issues in making their payments by placing delinquent amounts at the back end of the loan, once the borrower makes two regular monthly payments. The foreclosure avoidance program has been in place since 2004 and is designed to help customers experiencing serious financial hardship. Temporary (six-month) and permanent relief are available, based upon individual customer circumstances. The program is designed to lower the interest rate and payment amounts to levels that allow customers sufficient post-payment disposable income to meet their other expenses.

All three of HSBC's programs use standardized guidelines to determine qualification, including the type and amount of assistance provided. Once a customer qualifies, HSBC considers the individual needs of each borrower on a case-by-case basis. Like the representatives from the other institutions that testified before him, Mr. O'Leary stated that HSBC's greatest challenge is hearing from borrowers.

Questions From Committee Members

Before excusing the lender and servicer panel, the Chair asked them whether their outreach programs had altered the number of defaults they were seeing. The lending institutions answered that their outreach efforts have definitely had a positive effect, but that both defaults and foreclosures are continuing to increase. However, the number of loan modifications was increasing faster then either defaults or foreclosures, indicating the positive impacts of their efforts.

Senator Florez asked the panel about what role lenders played in creating the existing situation by promoting easy credit and encouraging borrowers to cash out on the equity in their homes. Mr. Delgado expressed a frustration felt by all of the institutions at the witness table. He responded that lenders can't keep people from making poor decisions, and that borrowers who wish to tap the equity in their homes may do so; lending institutions won't stop them. However, one of the key problems Mr. Delgado and others are seeing in this marketplace is an unwillingness of some borrowers to take the steps necessary to save their homes. He noted that it is very difficult to convince some borrowers to forsake their cell phones and their satellite bills in order to make their mortgage payments.

Counseling Organizations

Lupe Hernandez, Management Consultant with NeighborWorks America, led off the panel by introducing her organization as a congressionally-chartered, national non-profit organization that provides grants, technical assistance, and training to more than 235 community-based organizations across the country. NeighborWorks America believes itself to be the original public/private partnership model and has replicated that successful model in over 4,400 communities around the country. NeighborWorks organizations operate in all 50 states, the

District of Columbia, and Puerto Rico, and in America's urban, suburban, and rural communities.

Over the past five years, NeighborWorks has helped nearly 100,000 families of modest means become homeowners, 91% of which were families of low-income and 53% of which were families of ethnic or racial minorities. During the same time period, NeighborWorks owned and managed more than 63,500 affordable rental housing units; provided homeownership education and counseling to over 317,000 families; trained and certified nearly 50,000 community development practitioners from over 5,000 organizations and municipalities nationwide; and facilitated over $9 billion in investments in distressed communities nationwide.

Ms. Hernandez' testimony focused on NeighborWorks America's efforts to preserve homeownership and respond to the recent rise in foreclosures. NeighborWorks America has over 30 years of experience providing pre-purchase housing counseling, financial fitness training, and working with borrowers to improve their credit ratings. Over the years, it has learned that the best defense against delinquency and foreclosure is objective education and advice before the borrower begins shopping for a home and a mortgage. That education and advice can be offered through national organizations like NeighborWorks, through local NeighborWorks-affiliated counselors, and through other local, HUD-approved nonprofit housing counseling agencies.

Ms. Hernandez' backed up this assertion with statistics showing that low-income families that have received assistance of some form from NeighborWorks organizations are ten times less likely to enter foreclosure than subprime borrowers who have not received counseling from NeighborWorks and slightly less likely to go into foreclosure than prime borrowers.

Several years ago, NeighborWorks America created the Center for Foreclosure Solutions to build capacity for foreclosure counseling across the country, conduct public outreach campaigns to reach struggling homeowners, research local and national trends to develop solutions to avoiding foreclosure, and establish sustainable foreclosure intervention programs. Ms. Hernandez reminded the Committee about the many costs of foreclosure – to the borrowers who lose their homes, the neighborhoods in which these homes are located, the communities that rely on property taxes, and the lenders whose costs increase.

She then spoke about the HOPE hotline, a national toll-free hotline for delinquent borrowers that NeighborWorks America is promoting in partnership with the Homeownership Preservation Foundation. The toll-free number (1-888-995-HOPE) is staffed 24 hours a day, 7 days a week by trained operators who are fluent in English and Spanish. Individuals calling the hotline are connected with a trained counselor and can get help developing a written financial plan, contacting their lender to discuss payment options and loan restructuring, or, if they need more intense service than can be provided over the phone, are referred to local HUD-approved counseling agencies. So far during 2007, the HOPE hotline has counseled over 6,100 Californians (compared to 650 homeowners during all of 2006).

The key to helping as many people as possible through the HOPE hotline is getting them to call as soon as possible. To accomplish this, NeighborWorks America launched a public service advertising campaign supported by the AdCouncil to encourage borrowers in trouble to call the HOPE hotline. The campaign was initially distributed to over 30,000 media outlets nationwide.

Ms. Hernandez closed by urging the mortgage finance industry, financial regulators, real estate professionals, and the Legislature to work together in the following areas: 1) on the pure-purchase side, there should be increased emphasis on and support of quality housing counseling and consumer education, and on the importance of providing understandable loan disclosures to borrowers; 2) on the post-purchase side, there should be resources available to build and sustain post-purchase counseling efforts, and to encourage the lending and servicing industries to work with housing counselors and community groups to make their servicing operations more accessible to counselors; 3) in the area of regulation, NeighborWorks America urges improved oversight of lenders and brokers, with a focus on curtailing predatory and deceptive lending practices and providing guidance to servicers, encouraging them to initiate loan modifications on securitized loans; 4) NeighborWorks also believes that industry should be encouraged to reintroduce real-estate owned (i.e., foreclosure) housing stock back into the community.

Jeff Schrager, Team Leader of No Homeowner Left Behind, introduced himself as a licensed real estate broker, President of Realty Blue, Inc. in Fresno, Vice-President of the Community Housing Council in Fresno, a non-profit organization that promotes sustainable homeownership in Fresno County, and the lead developer of Fresno's local foreclosure prevention initiative called No Homeowner Left Behind (NHLB).

NHLB began nearly a year ago through discussions Mr. Schrager had with Rollie Smith, the Central Valley Regional Director of HUD in Fresno. Both men wanted to overcome the major barriers that at-risk homeowners and resource providers face when dealing with the complex process of foreclosure, including: 1) lack of access to information, 2) lack of knowledge about available resources by both homeowners and resource providers, 3) poor connections between resource providers, and 4) lack of a collective community-based response.

Hoping to avoid reinventing the wheel, the two men convened meetings with local non-profit organizations, lenders, realtors, HUD-approved counseling agencies, local government agencies, credit counselors, attorneys, tax professionals, consumer advocates, and crisis counselors. From those meetings, they identified what was working in other areas of the country, what their present resources and capacities were to respond, what their limitations were, and what methodologies of service provision would provide at-risk homeowners with the best possible outcomes.

The goal of the working group and NHLB is to ensure that homeowners have access to timely, accurate, unbiased information, and reputable professionals to help them preserve home ownership when feasible, and to minimize loss of equity and other adverse impacts when retention of homeownership is not possible.

NHLB's strategy includes three focus areas: prevention, intervention, and impact mitigation. Typically, these focus areas translate into educating resource providers about available resources and products, performing consumer outreach, developing action plans with consumers, referring consumers to available resources such as the HOPE hotline, following up with consumers, and tracking and reporting outcomes. Mr. Schrager provided the Committee with a handout illustrating some of the ways in which NHLB's model operates (see Section 3).

To date, Mr. Schrager's team has trained approximately 40 volunteer resource providers, engaged and gained the support of local media to publicize its existence and its services, created a web site (www.nohomeownerleftbehind.org), established a local hotline staffed by 11 English and Spanish speaking volunteers 24 hours a day, 7 days a week, and conducted a local mortgage checkup event attended and supported by lenders. Mr. Schrager believes that NHLB's model is low-cost and high-impact, and feels that community-based cooperatives like his can be exported to other areas of the state.

Despite its successes, NHLB continues to struggle with the following challenges: 1) difficulties in contacting the appropriate decision makers in lender' and servicers' loan servicing and loss mitigation departments; 2) insufficient knowledgeable resource providers and one-on-one local loss mitigation counselors; 3) lack of capacity to respond to cases of elder abuse and fraud with which it comes into contact; 4) insufficient funding for local infrastructure; and 5) lack of viable strategies and refinance products to deal with no-equity situations, predatory lending situations, and situations in which delinquency or default has limited a borrower's refinancing options.

Mr. Schrager wished to leave the Committee with three takeaways. First, NHLB and its partners are providing services now at the local level, but funding is critically needed for its program partners. Second, two of NHLB's greatest strengths are: 1) the increased awareness about available resources that it generates among at-risk homeowners and resource providers, and 2) the enhanced collaboration it encourages among different resource providers. Finally, the biggest immediate benefit of NHLB's model is the peace of mind and feeling of being back in control that it gives at-risk homeowners, by improving their understanding of the foreclosure process and making them aware of new options they can use to help themselves now.

Martha Lucey, President of ByDesign Financial Solutions, is one of the community partners that participates in NHLB. ByDesign is a non-profit, HUD-certified counseling organization that provides credit counseling, housing counseling, and financial education. It has twelve offices throughout central California, in Sacramento, Stockton, Fresno, and Los Angeles.

ByDesign has offices in three of the top five markets in the nation with the highest foreclosure activity and has been deluged by homeowners who are currently having trouble making their mortgage payments or who are anticipating having trouble making their payments in the near future. Ms. Lucey stated that many of these homeowners did not get adequate pre-purchase education and secured mortgages with questionable affordability. She believes that these homeowners now require counseling on their options for preserving homeownership, when possible, or in minimizing their financial loss when there is no way to keep their homes. She stressed that lender initiatives, national initiatives, and local initiatives are all necessary.

At ByDesign, counseling is provided in intensive, two hour sessions by a HUD-certified counselor. Counseling sessions include detailed analyses of the borrower's household budget, income and expenses, the tradeoffs one needs to make to preserve homeownership, a review of the borrower's home equity position, their loan, their credit report, and an overview and analysis of their options. In some cases, the counselor calls the lender's loss mitigation department on behalf of a borrower, when the borrower can't bring him or herself to do so directly.

Ms. Lucey noted that the surge in calls from homeowners has significantly strained ByDesign's resources. Although it is a non-profit, ByDesign does have to pay its professional staff, and it has insufficient resources with which to employ sufficient staff to meet increasing demand. Historically, ByDesign's primary support for default counseling was annual competitive-bid funding from HUD. This year, HUD funding paid for less than two month's worth of ByDesign's activity. ByDesign has reached out to the lending community to help meet some of the gap in funding, but has received a luke-warm response. Some lenders, such as Wells Fargo, have provided financial support for counseling and have been willing to work with ByDesign in the community to reach out to borrowers. Other lenders have been less enthusiastic.

Ms. Lucey expressed frustration at the unwillingness of some lenders to support organizations like hers, noting that many homeowners prefer to work with counselors in their community. ByDesign only has the financial support to offer about 40 counseling sessions per week, and must refer many callers to the HOPE hotline.

Echoing the comments of Mr. Schrager, Ms. Lucey noted that ByDesign has had a mixed response from the lending community when trying to obtain sustainable workout options for its clients. Getting in touch with the lenders' loss mitigation departments can be difficult, and sometimes even after they manage to reach the right person, they are unable to obtain a loan workout plan. She noted that while some homeowners have no option but to lose their home, others would be able to remain in their homes if they could obtain a loan modification. Turning a variable rate loan into a fixed rate loan or putting arrearages at the end of the loan would have helped several borrowers but were unavailable as options from loss mitigation departments.

Ms. Lucey also stated that while the primary goal of default counseling is preserving homeownership, the counseling also has benefit for borrowers who are unable to retain their homes. In those cases, counseling on how to secure rental housing, rebuild credit, and access other support services can help a family move beyond the crisis of losing its home.

Finally, Ms. Lucey concluded that early outreach to homeowners is the most effective strategy. Mortgage check-up events and counseling on the family budget before there is a mortgage delinquency are very effective.

Questions Posed by Committee Members:

Chairman Machado stated that it appeared from the testimony of the counseling organizations that many of the initiatives described by industry may not be as widespread and as readily available as industry suggested. The counseling organizations agreed that often the lenders' initiatives do not reach all the way down to the local level.

The Chair also asked whether the counseling organizations encountered any greater difficulties in accessibility and/or willingness to work on loan modifications among servicers who hold securitized loans relative to lenders who hold loans they originated. The panel did not see any great differences. Instead, they asserted that their greatest difficulty is getting through to the proper people at the lending institutions. As a nationally-based counseling organization, NeighborWorks finds it slightly easier to access the right people than do the local counseling groups.

Senator Correa asked the counseling organizations whose interests they were protecting (i.e., were they trying to strike a balance between the fiduciary responsibilities servicers have to their investors and the needs of borrowers or did they favor borrowers' interests over those of servicers). All three responded that they primarily existed to advocate on behalf of borrowers. They act as facilitators whose goal is homeownership preservation. However, they agreed that they have to work cooperatively with lenders and keep lenders' priorities in mind in order to get help for their borrowers. It does a borrower no good to propose a loan workout the lender will not consider.

Senator Cox questioned the panel on whether it made sense to charge borrowers for the counseling assistance they were seeking as a way to help address some of the resource constraints the counseling organizations were experiencing. The counselors generally agreed that borrowers seeking counseling were not in a financial position to afford the $250 a counseling session might cost them. This prompted a question from Senator Correa about whether borrowers understand what they're in for if they do lose their house through foreclosure. Martha Lucey spoke for the group in responding, "No, they don't. Borrowers are often paralyzed and don't know what to do. They don't realize that there are options out there that can help them."

Senator Florez asked the group what legislators should tell a borrower who contacts a Member's office in trouble on their loan. The counseling organizations were unanimous in their responses: Contact their lender immediately or contact a HUD-certified counselor immediately.

Senator Cox asked about the 50% of people whose homes are foreclosed on who don't pick up the phone to contact their lenders. Were the lenders not calling them? The counseling organization representatives explained that the lenders are calling; the people are simply not picking up the phone. For this reason, a multi-faceted approach is the best way to reach out to borrowers. Trying to contact borrowers through multiple different channels and giving them multiple different ways of getting help is the best solution.

The Chair then asked the panel what percentage of their contacts had helped people avoid foreclosure. Ms. Lucey responded that about 60% to 80% of the borrowers who contact her organization are so compromised, their homes cannot be saved. However, she did stress that her organization could help them in other ways. Mr. Schrager echoed Ms. Lucey's results. Ms. Hernandez stated that her organization is able to help 32% of the people who contact NeighborWorks and work with them throughout the process to avoid foreclosure (i.e., the same range of success as Ms. Lucey's and Mr. Schrager's experiences).

Before adjourning the panel, the Chair asked the panelists what the Committee should take away from their testimony. The panel agreed on four responses: 1) support HUD-certified counseling agencies, 2) promote local and national hotline numbers, 3) fund outreach initiatives to reach borrowers, and 4) develop loan products for at-risk borrowers that provide them with affordable and sustainable homeownership opportunities.

The Chair then excused them, observing that none had suggested a need for state statutory or regulatory changes.

Federal Regulator Panel

Stan Ivie, Regional Director for the Federal Deposit Insurance Corporation's (FDIC's) San Francisco Office, stated that nearly three quarters of securitized subprime loans originated in 2004 and 2005 were 2/28s and 3/27s. 1.1 million of those loans are set to reset in 2007, and another 882,000 are set to reset in 2008. Many of these borrowers will have trouble making their payments once their low introductory interest rates reset.

Mr. Ivie also observed that not all borrowers are the same. These loans were given to four groups of borrowers – 1) borrowers who couldn't afford even the low introductory interest rate of the loans they were sold; 2) borrowers who were speculating on the real estate market or involved in fraud, who generally should not be helped; 3) borrowers who could have qualified for a prime loan but were sold a subprime loan – these borrowers ought to be able to refinance into fixed rate and/or prime loans; and 4) borrowers who could afford their low introductory interest rates but cannot afford their new higher rates. It is this fourth group that is the focus of FDIC's recent regulatory efforts and the group that the FDIC believes should receive restructured loans they can afford over the long-term.

In April 2007, the FDIC, along with the other four federal banking regulators, issued the Statement on Working with Borrowers, in which they encouraged financial institutions to work cooperatively and proactively with borrowers to find more affordable, sustainable products to help avoid foreclosure. The Statement noted that: 1) lenders will not face regulatory penalties for working with borrowers to help them avoid foreclosure, 2) lenders may be eligible for Community Reinvestment Act (CRA) credit for moving borrowers from high-cost to low-cost products, 3) existing regulatory guidance and accounting standards do not require lenders to immediately foreclose on properties in lieu of trying to work with borrowers, and 4) financial institutions should work with community-based organizations to help reach out to borrowers. The FDIC is seeing many financial institutions proactively contacting borrowers, but noted that borrowers should contact their lenders as soon as possible if they find they will be unable to afford their mortgages. Mr. Ivie also noted that most subprime loans are not currently held by FDIC-insured banks.

The April 2007 statement is intended to help address the borrowers who are currently facing loan resets. In order to help ensure that future borrowers don't run into the same sorts of problems existing borrowers are facing, the FDIC was also involved in jointly issuing the June 2007 Subprime Lending Statement. That statement called for stronger underwriting of subprime adjustable rate mortgages and better consumer disclosures on subprime adjustable rate mortgages with the potential for payment shock.

Without contradicting the testimony of George Miller, Mr. Ivie did state that securitization has complicated the ability of financial institutions to work with borrowers. To help address some of these challenges, the FDIC has also worked with some of the other federal regulators to convene a series of regional forums to help identify solutions. The FDIC has also directed its Alliance for Economic Inclusion, a working group intended to help undeserved communities, to promote foreclosure prevention strategies in nine specific areas across the country, including Los Angeles. The FDIC has also partnered with NeighborWorks to support foreclosure prevention strategies.

John Olson, District Manager for Community Development with the Federal Reserve Bank of San Francisco (FRBSF), discussed the homeownership preservation work the FRBSF has engaged in. While other divisions of the Federal Reserve Board have been involved in regulatory and market responses to addressing the mortgage market problems, his group has spearheaded the FRBSF's education and outreach response. In response to trends it was observing in the mortgage market, the FRBSF devoted its entire December 2006 edition of Community Insights (its quarterly bulletin) to foreclosure prevention. In doing the research for that publication, FRBSF learned that one of the most important components of a successful local response to avoiding foreclosures is use of a community-based collaborative outreach effort to borrowers. Successful community-based, collaborative outreach efforts should stress the importance of connecting borrowers with appropriate housing counseling as early as possible and encouraging them to work with their lenders and servicers.

Recognizing that community-based, collaborative efforts are the key to helping avoid foreclosures at a local level, FRBSF's community affairs office worked with the community affairs offices of other federal regulators to convene a series of forums titled, "Preserving Homeownership, Preserving Communities." The regulatory team convened six forums in May and June of 2007 in areas hard hit by foreclosures, including Fresno, Los Angeles, San Francisco, San Diego, Phoenix, and Las Vegas. The forums, which attracted over 700 participants, were designed to inform community development practitioners about the major causes and extent of the problem, share best practices for foreclosure prevention, and provide an opportunity for key local stakeholders to brainstorm how best to help their communities.

The FRBSF is working with local groups to implement some of the suggestions that came out of the forums. According to Mr. Olson, the FRBSF provides logistical and research support for existing, local collaborative efforts, facilitates the creation of neighborhood task forces, and is working on a web site devoted to foreclosure prevention which will, among other things, include the presentations made during its six forums.

Questions Posed by Committee Members

Chairman Machado asked the regulators whether they have a leadership role to play in encouraging the servicers they regulate to work proactively and cooperatively with borrowers. Both responded in the affirmative. Mr. Ivie noted that historically, his agency was focused more on the "held for sale" portfolio, but that its focus is increasingly shifting to securitized loans.

The Chair also noted the difficulty that many banks are having in getting borrowers to open up to them and asked what efforts the federal regulators were taking to support counseling efforts. Mr. Ivie explained that the FDIC is partnering with NeighborWorks and encourages all of its regulatory institutions to partner with local counseling organizations to provide education and outreach services. FDIC's institutions also receive favorable CRA consideration for working with low- or moderate-income borrowers or helping fund local counseling organizations in low- or moderate-income communities. Mr. Olson stated that the existence of CRA credit for the activities Mr. Ivie mentioned is well-known among the Federal Reserve Board's regulated institutions. He also echoed Ms. Lucey's comments about the existence of two levels of counseling (national and local) and stressed that local face-to-face counseling is very important. This counseling can be offered through a local network of trusted organizations such as churches, schools, and counseling organizations, and involves trusted people and institutions helping people understand they should reach out for help. The FRBSF is also working with financial institutions to provide training to people and organizations that wish to provide counseling.

State Regulator Panel

Before inviting the state regulators to begin their testimony, Chairman Machado acknowledged the efforts they've made to be responsive to the requests of the Committee and the needs of Californians and to move forward to implement regulations on nontraditional mortgage product risks and subprime lending. The Chair also thanked the panel for their outreach to Members of the Legislature through their involvement in putting on community town hall events.

Jeff Davi, Commissioner of DRE, led off the panel by stating that shortly after this Committee's January informational hearing, the Business, Transportation & Housing Agency (BT&H) assembled an interdepartmental working group on nontraditional loans that included DRE, DOC, DFI, the Department of Housing and Community Development and the California Housing Finance Agency. Working together, the group created the yourhome.ca.gov and sucasa.ca.gov web sites; brainstormed ways in which they could provide education, consumer outreach, and enforcement; and worked together to ensure consistency in their regulatory rulemakings implementing the nontraditional mortgage product risk guidance and the subprime lending statement. The group also worked together to put on mortgage assistance town halls in several locations throughout California, held stakeholder meetings with industry to roll out the yourhome.ca.gov and sucasa.ca.gov web sites and the initial town hall events, and developed working relationships with consumer groups to facilitate consumer complaints and open lines of communication between the consumer groups and the regulators. The working group also contacted other regulatory agencies, including the Federal Bureau of Investigation, HUD, State Attorney General, local district attorneys, the Department of Fair Employment and Housing, the Federal Reserve Board, and the U.S. Department of the Treasury to facilitate consumer complaint referrals and information sharing. Mr. Davi stated that he and his fellow Commissioners took every opportunity to seek out consumer complaints and to encourage borrowers to contact their lenders.

Preston DuFauchard, Commissioner of DOC, stressed the coordinated way in which the three departments had worked together. DOC reached out to all of its lenders, many of whom adopted

Senator Dodd's Homeownership Preservation Statement of Principles (see Appendix A for a copy of these principles). Commissioner DuFauchard also reached out to borrowers through his participation in the Fresno and the San Francisco homeownership preservation forums hosted by FRBSF and in three of the town halls put on by the Department of Consumer Affairs. The idea behind the town halls was putting borrowers in touch with their lenders as soon as possible, and he personally saw some success stories emerge from the town hall events.

Carol Chesbrough, Chief Deputy Commissioner of DFI, delivered a set of handouts to Committee members (see Section 3 of this report), including bulletins in which DFI directed its licensees to work with borrowers to the extent possible to avoid foreclosures. In May 2007, DFI also distributed a notice through its Internet list of licensees, encouraging them to attend the forums being held by the FRBSF and learn about ways in which they could outreach to borrowers.

Using the results of a survey conducted by DFI earlier this year, Ms. Chesbrough testified that only 27% of DFI's licensees reported having made nontraditional loans in the recent past, and that 90% of those loans were sold into the secondary market. One institution made 85% of those loans. That institution is currently under a cease and desist order issued jointly by DFI and the FDIC. Under the terms of that order, the institution has been directed to take all steps possible to work with borrowers that may be at risk of foreclosure.

In preparation for the hearing, DFI also reviewed the complaints it received this year. The department received a total of 105 mortgage-related complaints, only 28 of which involved DFI licensees and only two of which were foreclosure-related. These numbers did not reflect any increase in complaints over prior years.

Like DRE and DOC, DFI participated in the town halls being put on by the interdepartmental working group. DFI also sent one of its staff to participate in a meeting called by FDIC head Sheila Bair, during which she assembled all of the key federal banking regulators, the GSEs, and several lenders and investment banks to brainstorm approaches to problems in the mortgage market.

Ms. Chesbrough noted that the yourhome.ca.gov and sucasa.ca.gov sites have listings of HUD-certified counselors, and stated that one of the benefits of these sites was their ability to reach borrowers not comfortable coming forward to contact their lenders or a counseling organization directly. The anonymity of the Internet can provide some borrowers with a comfort level greater than that obtained through personal or phone contact.

Carrie Lopez, Director of the Department of Consumer Affairs, testified that her department has experience in consumer outreach efforts and in translating information for use by consumers, so was a natural addition in the interdepartmental working group. Her department received about 10,000 calls last year on real-estate-related matters.

The Department of Consumer Affairs produced the four mortgage assistance town halls held earlier this year (in La Quinta, Stockton, Riverside, and Sun Valley) and put together and distributed templates for use by Assemblymembers and Senators who wish to put on their own town halls. The town halls were designed as workshops rather than as lectures in which information would be provided. Ms. Lopez testified that the organizers spoke as little as possible during the town halls; they introduced the participants, "then got out of the way." Outreach to the community was key to the success of the town halls and was often accomplished using local legislators, because they were trusted by people in the community. Most of the people who attended the town halls sought information about their current mortgages, how to refinance, how to file a complaint, how to become homeowners, and where to get additional information. Key participants in the town halls included the California Bankers Association, California Association of Mortgage Brokers, HUD, the California Housing Finance Agency, NeighborWorks, DFI, DOC, and DRE. Spanish language translations were offered at many of the town halls. Ms. Lopez also noted that one of the keys to the success of the town halls was the absence of any sales pressure.

Questions Posed By Committee Members

Chairman Machado observed that products which prey on people in financial distress are frequently advertised with a tag line that the lender is licensed by DOC or DRE. He asked the Commissioners whether they can and do take action against these types of predatory ads. Commissioner DuFauchard responded that DOC does not have an opportunity to review specific products being offered by a licensee at the time of their license application. Instead, they must rely on consumer complaints to identify problematic products being offered by their licensees. Commissioner Davi stated that the ads to which the Senator referred reflected a product being misapplied, not necessarily a bad product. DRE does not have authority over the products, only over misuse of the products by its licensees. DRE's biggest dilemma is finding out about misuse of products by its licensees. Like DOC, it is largely reliant on consumer complaints.

Senator Florez asked the panel how the departments measure their success. Ms. Lopez responded that they had no hard numbers on the number of loan workouts they had been able to arrange through the town halls, nor the number of complaints on which action has been taken. Commissioner DuFauchard stated that the objective is to encourage borrowers to contact lenders, and that DOC may not be involved in that. It's therefore difficult for DOC to measure it's success. Commissioner Davi stated that complaints and mortgage fraud cases are way up, and that his department has taken enforcement action against 249 mortgage brokers in the past year. The Chair asked him to report back to the Committee on the number of complaints received by DRE and on the specific actions taken by DRE on those complaints. Senator Florez expressed concern that the departments were reactive and complaint-based rather than proactive in their enforcement efforts.

The Chair repeated a question he had posed to the federal regulators about how they could use their leadership roles with their licensees as a bully pulpit to encourage responsible actions by their licensees. Commissioner Davi stated that DRE places information of the sort to which the Chair referred in its bulletins but, upon further questioning from Committee members, acknowledged that it does not mail its bulletins to all of its members. Commissioner Davi explained that it would be very costly to mail information to each of DRE's over 500,000 licensees, but, upon further questioning from Senator Florez, acknowledged that DRE could include material in the mailings its sends licensees when they renew their licenses.

Commissioner DuFauchard also stated that his department could send a mailing to its licensees, encouraging them to reach out to borrowers earlier in the process. He testified that his department is looking at forming a steering committee with lenders and consumer groups to develop other ideas. Before dismissing the panel, Senator Machado asked the departments to brainstorm additional ways in which they could be proactive in reaching out to provide leadership to their licensees and in issuing behavioral guidelines and expectations. He stressed that he was encouraging prompt action, rather than action that required the lengthy regulatory rulemaking process. He directed the Commissioners to report back to the Committee on ideas regarding what they could do in these areas.

What More Should We Be Doing?

Bob Gnaizda, Policy Director and General Counsel of the Greenlining Institute, a multi-ethnic public policy and advocacy center, testified during the morning portion of the hearing, immediately after the lender and servicer panel, because of a scheduling obligation that required him to leave before the Committee recessed for Senate Floor Session at 11 AM. During his testimony, Mr. Gnaizda described a proposal that he has discussed with representatives of the Office of the Comptroller of the Currency, Federal Reserve Board, Office of Thrift Supervision, FDIC, and the House Financial Services Committee. The proposal calls on Federal Reserve Board Chairman Ben Bernanke, supported by the other federal regulators and by state and federal legislators, to convene an emergency meeting of major investment houses and banks and ask them to collectively create a $10 billion anti-foreclosure fund. The fund would be used to assist homeowners who occupy their homes and whose incomes are 120% of median income or less, by helping these people modify or refinance out of their adjustable-rate mortgages. Mr. Gnaizda testified that the greatest foreclosure problems are being experienced by the 70% of Americans who live paycheck to paycheck. Greenlining believes that the fund should be privately supported, but notes that Congress may consider a matching $10 billion after the first (privately-contributed) $10 billion is exhausted. Greenlining believes that only the Federal Reserve Board has the power to solve the foreclosure crisis quickly. It also believes that investment banks should play a key role in creating the fund, because over two-thirds of the subprime loans made in 2005 and 2006 were either originated, packaged, or securitized by investment banks.

Mr. Gnaizda noted that the vast majority of regulated financial institutions that have loss mitigation plans in place have very limited funds available and only assist a small number of those in need. Using recent estimates reported on CNN.com, he stated that each loan modification costs approximately $16,000. Mr. Gnaizda believes that up to one million families nationwide may need loan modification assistance, in order to stabilize home prices and slow down the foreclosure rate.

Greenlining believes that the financial institutions which contribute to the fund should run it, but notes that, as an alternative, the Federal Reserve Board could supervise the fund, with assistance from the other banking regulators, or the fund could be supervised by HUD or the GSEs.

Greenlining also expressed support for a proposal advanced by the California Reinvestment Coalition (CRC; see below) for a six month foreclosure moratorium.

Alan Fisher, Executive Director of CRC, described CRC as a statewide coalition of 250 California community-based organizations that have been working for over 20 years to increase the economic vitality of low-income neighborhoods and neighborhoods of color.. CRC testified out of concern for the half million or more Californians who may lose their homes as a result of subprime or stated-income loans, or because they were elderly or non-English speaking and were victimized by misleading loans.

Echoing many of the points made by the Chair in his opening remarks, Mr. Fisher noted that the loss of homeownership is just the first step in the economic and human impact of the subprime mortgage crisis now gripping California. If homes go vacant, neighborhoods lose value; this, in turn, creates a domino effect, which results in other homes losing value and becoming in danger of foreclosure. Homeowners become more financially stretched, retail sales drop, cities lose revenue, and employment decreases.

Mr. Fisher testified that California's regulatory and legislative response to the mortgage crisis has been inadequate. Other states have enacted foreclosure moratoriums to allow time for a full response to their state's mortgage crisis or have developed loan products that assisted borrowers. CRC hopes that this informational hearing will encourage the Governor and Legislature to get engaged to help families and neighborhoods, and, in doing so, help the state's economy.

CRC has identified three key elements of a solution to the mortgage crisis. First, lenders need to provide flexible and clear loan modifications for borrowers in trouble or soon to be in trouble. CRC members have met with the eight largest lenders to advocate for more flexibility in loan modifications and borrower assistance and have heard about many positive policies being implemented by these lenders. Yet, CRC members assisting troubled California borrowers report that those policies are uneven in their application, and in some cases do not seem to exist in practice. Smaller loan servicers are even less likely than the larger servicers to be responsive to borrowers' needs.

Second, borrowers need strong community-based organizations to assist them. Third, state and federal regulatory and legislative bodies need to institute strong oversight of lenders' loan modifications, require loan documents to be provided in the language of the borrower, and assist borrowers financially.

CRC has developed seven Homeownership Preservation Best Practices, which it urges the Legislature to find ways to support. More detail on these best practices is contained in the written testimony in Section 3. Among these practices: 1) strong loss mitigation policies to keep borrowers in their homes, including the offering of fixed-rate loans to at-risk borrowers; 2) clear channels of communication for counseling agencies having trouble resolving borrowers' issues and for legal service advocates trying to fix predatory loans; 3) willingness of lenders to waive prepayment penalties for borrowers trying to refinance out of unaffordable loans; 4) special rescue refinance loans for borrowers whose lenders have refused a loan modification, 5) provision of grant funds to borrowers in distress, 6) outreach and education of at-risk borrowers and support for nonprofit counseling agencies who offer these services, 7) willingness of lenders to offer nonprofit organizations the first opportunity to purchase foreclosed properties and willingness of the Legislature to assist nonprofit organizations with low-cost financing to purchase these properties; and 8) positive and strong regulatory oversight of mortgage lenders and brokers.

Mr. Fisher urged California to enact a moratorium on foreclosures and noted that Massachusetts has a 60-day moratorium applied to lenders. When questioned about the details of that moratorium, Mr. Fisher responded that the Massachusetts program allows borrowers to file a complaint about their lender with the state's banking department. Once a complaint has been filed, foreclosure action by the lender is delayed, while the banking department investigates the claim. CRC called on California to enact a six-month moratorium on foreclosures, but did not specify whether California's moratorium should look like Massachusetts' complaint process or be an out-right ban on foreclosures on all loans.

Paul Leonard, California Office Director of the Center for Responsible Lending (CRL), began his testimony by introducing his three main points. First, California has seriously lagged behind other states in its response to the meltdown in the mortgage market. Second, there are a number of steps California can take to minimize foreclosures and stabilize housing markets, including the provision of emergency funding for foreclosure prevention counseling and legal assistance, the establishment of a state monitoring system for loan modification, and the creation of a targeted refinance product to help borrowers refinance their loans. Third, California should enact comprehensive legislative changes to return subprime lending to more responsible standards, such as requiring lenders to evaluate borrowers' ability to repay their loans, eliminating risky product features for subprime borrowers, and making structural changes to the roles of lenders, brokers, and investors in the origination of mortgages.

In expanding on these three points, Mr. Leonard chastised California's efforts in relation to other states. He stated that California's anti-predatory lending law (the Covered Loan Law) is weaker than similar laws in other states that have acted in this area. He also believes that California has failed to move quickly enough to apply federal nontraditional mortgage product risk guidance and the federal subprime lending statement to state-regulated mortgage lenders and brokers.

CRL proposes that the state appropriate $5 million to $10 million to support foreclosure prevention counseling and legal services intended to help at-risk borrowers. Noting that loan modifications offer the most promising alternative for borrowers, taxpayers, and mortgage markets, he urged the state to establish a reporting and monitoring system for loans that are modified. While lenders profess a desire to avoid foreclosures, there are few mechanisms in place to track the outcomes for borrowers who participate in loss mitigation efforts. No data are regularly reported by lenders regarding how many borrowers who participate in loss mitigation efforts avoid foreclosure, nor on the terms of the loan modifications they approve. Mr. Leonard believes that a comprehensive reporting and monitoring system would greatly increase the accountability of servicers' loan modification efforts, and allow the public and policymakers to gain a greater understanding of which loss mitigation practices and which servicers are most effective in achieving long-term affordability outcomes for borrowers. CRL believes that state policymakers should also work with servicers to develop transparency and objective standards for loan modifications. Because each loan modification is evaluated on a case-by-case basis, there is no way for borrowers to know the best terms for which they could qualify and no guarantees that similarly situated borrowers will be treated equally.

CRL also believes that California should join other states like Massachusetts, New York, Colorado, and Ohio in utilizing bond funds to develop refinancing products for borrowers at risk of foreclosure. Mr. Leonard believes it is critical that any such state resources be contingent upon significant financial concessions by servicers and investors. State resources should not be used to make investors whole, thus bailing them out of bad investment decisions. Mr. Leonard suggested that lenders be required to refinance properties at the lesser of 90 percent of the current appraised value of the property or the estimated foreclosure value of the property.

Finally, CRL urges the Legislature to enact legislation to ban prepayment penalties on subprime loans; require mortgage originators to assess the ability of borrowers to repay their loans, based on the fully-indexed interest rate and fully amortized payments, while using a debt-to-income ratio that considers property taxes, hazard insurance, and other debts; require lenders to verify and document all sources of borrower income; require lenders to underwrite subprime loans to include the cost of hazard insurance and property tax in their ability to repay calculations; require lenders to establish escrow or impoundment accounts for tax and insurance payments; make lenders liable for acts and omissions of the brokers with whom they do business; and revise the Covered Loan Law to include yield spread premiums in the calculation used to determine which loans qualify as "covered."

Public Comment

Sandy White, with Housing Core Mortgage (www.housingcore.com), stated that she was representing borrowers who received loans that had been misrepresented by the loan community. She expressed concern that there were no consequences for the actions of the real estate agents and loan officers who commit fraud and expressed frustration that the opportunity to modify a bad loan was often not there. She suggested that the Committee review guidelines that had been issued by the California Association of Notaries and complained of problematic appraisal practices involving mortgage loans.

Two individuals with the Association of Community Organizations for Reform Now spoke of their personal experiences obtaining loans they could not afford.

Norma Garcia with Consumers Union stated that she was back again to testify before many of the same people she had addressed during the Covered Loan Law discussion in 2001. She urged mandatory counseling for all high-risk loans; regulating lending practices on the front end through suitability standards or similar methods for matching borrowers with loans that are appropriate for them; and removing motivations, such as yield spread premiums, that caused lenders to put borrowers into loans they couldn't repay. She testified that creating greater borrower disclosures was helpful, but no substitute for real reform. She encouraged the Legislature to revisit proposals that were rejected several years ago, and to make sure that lenders and servicers are engaging in real-life workouts. She urged California to look at what other states have done. She concluded by reminding the Legislature that this is a serious problem – if we can respond as quickly as we did to contaminated spinach, we ought to be able to respond quickly to problem loans.

APPENDIX A

RESPONSES TO THE COMMITTEE FROM THE DEPARTMENTS OF FINANCIAL INSTITUTIONS, CORPORATIONS, AND REAL ESTATE

Department of Financial Institutions Survey

August-07

Directions and definitions for each section are in the gray areas. Your answers are to be entered in the white areas.

If you wish to print this survey, use the landscape format.

Further instructions for this survey can be found in the e-mail to which it was attached.

ALL LOAN BALANCES MUST BE PRESENTED IN THOUSANDS.

1. Licensee Information (to be completed by all licensees)	
Department of Financial Institutions charter/license number:	
Institution name:	
Person who prepared this report:	
Preparer's title:	
Telephone number:	
Email address:	

Licensee Involvement with Non-traditional Mortgage Products For questions 2 through 4 please mark an "x" in the box that corresponds with your answer for the question.	Yes	No
2. Does your institution hold non-traditional mortgage products? (If yes, go to question 5 (a-e) and question 6 (a-e).		
3. Does your institution provide mortgage servicing for loans not held by your institution? (If yes, go to questions 7 and 8).		
4. Does your institution hold acquisition, development, and construction (ADC) loans or other construction and development loans? (If yes, go to question 9).		

PLEASE MAKE SURE ALL LOAN BALANCES ARE PRESENTED IN THOUSANDS.

5. Non-Traditional Mortgage Products

Please show the dollar volume of loans, number of loans, and loan delinquencies as of August 31, 2007.	Balance $	#	Delinquency					
			0 - 30 days		31 -89 days		90 + days	
			Balance $	#	Balance $	#	Balance $	#
a. Interest-only Mortgage Loan*								
b. Payment Option ARM *								
c. Reduced Documentation*								
d. Simultaneous Second-lien Loan*								
e. Other*								
(Describe Other)								

6. Non-Traditional Mortgage Products - Foreclosures, short-sales, and workouts

Please show the dollar volume and number of loans that have been subject to foreclosure*, short-sale, or have been subject to rewrite or workout from January 1, 2007 through August 31, 2007.	Foreclosures** or Short-Sales						Rewrites and Workouts***		
	Total		Cumulative Loss		Cummulative		Balance $	Cumulative Loss $	#
	Balance $	#	Balance $	#	Balance $	#			
a. Interest-only Mortgage Loan*									
b. Payment Option ARM*									
c. Reduced Documentation*									
d. Simultaneous Second-lien Loan*									
e. Other*									
(Describe Other)									

*Definitions

a. Interest-only Mortgage Loan	A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

payments include both principal and interest.

b. Payment Option ARM	A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.
c. Reduced Documentation	A loan feature that is commonly referred to as "low doc/no doc," "no income/no asset," "stated income" or "stated assets." For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.
d. Simultaneous Second-lien Loan	A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.
e. Other	Non-traditional mortgage that does not conform to the definitions in categories (a) through (d). Please provide a brief description in the space provided.

** Include only those foreclosures that were subsequently sold and a gain/loss was recorded.

*** Rewritten/workout options would include refinancing into a more affordable mortgage, loan modifications that change one or more of the loan terms, such as interest rate reduction, reduction of the outstanding principal balance, extension of the loan term or adding delinquent interest to the unpaid principal balance.

PLEASE MAKE SURE ALL LOAN BALANCES ARE PRESENTED IN THOUSANDS.

Survey continued on next page.

7. Mortgage Servicing - Loans not held by your institution

Loan Servicing Volume		
Total Loan Balance	#	Number of entities for which your institution is providing loan servicing.

8. Briefly describe the parameter you have been given by the serviced entity (entities) to deal with loans that have a probability of default or are in the process of foreclosure (rewritten/workout options would include refinancing into a more affordable mortgage, loan modifications that change one or more o the loan terms, such as interest rate reduction, reduction of the outstanding principal balance, extension of the loan term or adding delinquent interest to the unpaid principal balance; or non-retention options such as foreclosure, short-sale, or deed in lieu of foreclosure).

9. Construction and ADC** Loans**

Loan Type	Balance $	#	Loans that have a term/take-out commitment by a permanent lender Balance $	#
a. ADC**** Loans				
b. Other Construction/Development Loans				

****An ADC loan is an arrangement in which a financial institution provides financing for real estate acquisition, development, or construction purposes and participates in the expected residual profit resulting from the ultimate sale or other use of the property.

PLEASE MAKE SURE ALL LOAN BALANCES ARE PRESENTED IN THOUSANDS.

End of Survey - Thank you for your time.

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)EPARTMENT OF CORPORATIONS

:alifornia's Investment and Financing Authority

August 31, 2007

The Honorable Michael Machado, Chair
Senate Banking, Finance & Insurance Committee
State Capitol, Room 5066
Sacramento, California 95814

Dear Senator Machado:

Please accept my gratitude concerning your focus and continued efforts to understand and address the current issues involved in the residential mortgage markets, in particular as they affect subprime borrowers. In that same spirit, I appreciate the opportunity you gave me to participate in the informational hearing "Preserving the American Dream: Home Ownership Preservation and the Subprime Mortgage Crisis." As follow up to that hearing, I understand that you would like information regarding the Department of Corporations' ability, within the existing regulatory structure, to prevent foreclosures by: 1) encouraging mortgage loan servicers to assist distressed borrowers to obtain modified loan terms or appropriate refinancing and to place borrowers in suitable loan products, 2) reviewing workout arrangements and evaluating whether the arrangements are fair to the borrowers in light of the obligation of servicers to maximize the returns for investors, and (3) assuring that the workouts result in consistent treatment of borrowers, such that similarly situated borrowers receive essentially the same consideration and workout arrangements. In response to those questions, I submit the following information, and plan.

<u>Existing Authority and Department Role Regarding Servicers:</u>

With regard to the Department's ability to review workout arrangements and evaluate the appropriateness and consistency of such arrangements, the Department's authority to regulate note-servicing activities is limited by law to impound and payment activities. As such, the review and evaluation of workout arrangements has not been part of the examination protocols, nor has the Department previously collected information regarding such arrangements. The Department's pending regulations adopting the Guidance on Non-Traditional Mortgage Product Risks ("Guidance"), which incorporates the Statement on Subprime Mortgage Lending ("Statement"), include provisions that require licensees to report information on workout arrangements related to complaints. Therefore, the Department will receive information regarding workout arrangements that are associated with a complaint to help the Department determine compliance with existing laws. For example, a workout arrangement may be indicative of a case where the borrower's ability to repay a loan was not taken into consideration as required by law.

Even with the proposed rules, then, the bulk of workout arrangements will ordinarily not be subject to Department review. In many respects that is understandable since servicer modifications represent the execution of their contractual obligations to their counterparties, contracts that the Department has no role in regulating. I agree, however, that in light of the current market climate, there should be some degree of transparency in the actions servicers are taking with respect to borrowers.

Proposal and Plan for Department Review of Servicer Workouts:

With regard to encouraging licensees to work with borrowers to implement workout arrangements and place them in appropriate loan products, I have a draft Commissioner's Release that will be sent to licensees requesting that they make concerted efforts to work with distressed borrowers to provide workout arrangements, consistent with appropriate business practices. Specifically, I am going to request that licensees adhere to U.S. Senator Chris Dodd's Homeownership Preservation Principles in their dealings with distressed homeowners.

In addition, the Department will work with a broad based Mortgage Lending Advisory Committee that I am organizing to make sure the Department collects data regarding workouts being arranged. Also, this group will develop objective criteria to measure the implementation and effectiveness of the application of these principles, and issue a report regarding the effectiveness sometime next year. This Advisory Committee will be comprised of industry participants and consumer advocacy groups, and will hold its first meeting in October 2007.

Many of the Department's licensees, particularly the larger entities, have already committed to adopting and applying Senator Dodd's Homeownership Preservation Principles. In fact, the very institutions represented at the August 21, 2007 informational hearing have agreed to this set of principles. Through these efforts, the Department hopes to promote transparency for workout plans being arranged, and assure they are fairly made and distributed, within the contractual agreements servicers have with the noteholders.

Finally, to assure that California borrowers receive equal and consistent treatment across lending platforms and institutions, I am proposing to send a letter to other state and federal regulators of mortgage servicers to encourage them to adopt an approach similar to California's initiative. If widely adopted, we will have a coordinated response from state and federal regulators to ensure consistency in the way that lenders and servicers treat borrowers. I have always been a proponent of a coordinated regulatory response to the current market environment. Such an approach will assure consistency for borrowers, lenders, and other market participants, and avoid any possible exploitation of the federal-state regulatory divide.

Thank you for this opportunity to provide my thoughts and proposals to address the issues we share an interest in resolving. I will keep you apprised of the status of the Department's efforts. I look forward to continuing to work with you to address the serious situation in the subprime mortgage market.

Should you or your staff have any questions or would like to further discuss the Department's proposed actions, please contact me at (916) 324-9011.

Sincerely,

Preston DuFauchard

Preston DuFauchard
California Corporations Commissioner

cc: Eileen Roush, Consultant – Senate Banking, Finance & Insurance

State Of California
Business, Transportation And Housing Agency
DEPARTMENT OF CORPORATIONS
California's Investment and Financing Authority

www.corp.ca.gov

Arnold Schwarzenegger
Governor

Preston DuFauchard
California Corporations Commissioner

DATE: SEPTEMBER 5, 2007

RELEASE No. 61-FS

ARRANGING WORKOUTS FOR BORROWERS, PREPARING FOR SPECIAL SERVICING REPORTS TO THE COMMISSIONER, AND ESTABLISHING A WORKING GROUP IN CONNECTION WITH NONTRADITIONAL AND OTHER MORTGAGE LOAN PRODUCTS

This Release encourages lenders and servicers of loans under the California Finance Lenders Law and the California Residential Mortgage Lending Act to provide appropriate workout arrangements with financially stressed borrowers, such as providing loan modifications and other workout arrangements. This Release also provides notification of a special report requested by the Department of Corporations ("Department') in connection with workout arrangements being arranged by licensees performing loan-servicing activities. Additionally, this Release announces plans to form a new working group to advise the Department, and provide further assistance to help measure licensee performance in providing workout arrangements to borrowers.

Workout Arrangements With Financially Stressed Borrowers

The California Corporations Commissioner encourages licensees to work with financially stressed homeowners to provide, as necessary and appropriate, workout arrangements that provide modified terms or converted loan products with predictable and manageable payments. Loss mitigation techniques for servicers have proven useful to preserve homeownership and to avoid foreclosure. Accordingly, the Commissioner urges servicers to identify borrowers who are potentially in distress early, to notify them of reset provisions, and to work with them as appropriate, consistent with the following additional statements dated September 4, 2007: (1) the "Statement on Loss Strategies for Servicers of Residential Mortgages" published by the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Conference of State Bank Supervisors ("CSBS"); and (2) the Joint Release published by the FDIC, the CSBS, and the American Association of Residential Mortgage Regulators ("AARMR") entitled "FDIC, CSBS and AARMR Suggest Servicers Avoid Debt-to-Income (DTI) Ratios Above 50 Percent for Modified Obligations."

Special Report Regarding Adherence to Homeownership Preservation Principles

In a separate form that will be sent to licensees, the Department will be requesting information by December 31, 2007, relating to compliance by loan servicers with principles dated May 2, 2007 by the United States Senate Committee on Banking, Housing and Urban Affairs and entitled, "Homeownership Preservation Statement of Principles" (hereinafter the "Principles"). In general, six of these important Principles impacting licensees (exclusive of those that apply to government sponsored entities) are as follows:

1. **Early Contact and Evaluation**: Servicers should attempt to contact subprime adjustable rate mortgage (ARM) borrowers prior to the loan reset to determine whether the borrower can afford the new, higher payments, or whether the higher payments create a reasonable risk of default. If it is clear, after reviewing all the available facts and circumstances, that the borrower will be unable to make the new payment when the loan resets, then the servicer may presume that default on the mortgage is reasonably likely to occur. This conclusion may permit the servicer to modify the loan.

2. **Modify to Create Longterm Affordability**: If the borrower cannot afford the reset payment (as described above), servicers should seek to modify loans prior to the reset. The objective of the modification should be to create a permanent solution for the borrower to ensure that the loan is sustainable for the life of the loan rather than, for example, deferring the rate reset period. Such modification options should include, as appropriate, one or more of the following:

- Change of terms. Switching from an adjustable to a fixed rate loan at an affordable rate by, for example, making the introductory rate permanent.
- Reduce the interest rate. Reducing the interest rate is one way to assist a borrower to afford the mortgage. Ability to repay should take into account the borrower's total debt-to-income ratio, including factoring in the costs of taxes and insurance.
- Reduce principal. Reducing the loan principal in order to ensure affordability and a continued revenue stream on the loan.
- Reamortize the loan. Reamortizing the loan to account for any changed loan terms or to make the payments more affordable.
- Escrows. If possible, servicers should begin to escrow for taxes and insurance as part of the modification process to ensure the home loan will remain sustainable for the life of the loan.

3. **Dedicated Teams or Resources**: Servicers should adopt a modification policy so that modifications can be done on the scale required in the time required by dedicated teams or dedicated resources. Where feasible, servicers should partner with

experienced third party counselors and non-profits to make outreach as effective as possible.

4. **Low-Cost Refinancing**: For those who are eligible, refinancing to prime loans should be made in as streamlined and low-cost fashion as possible.

5. **Maximize Success, Minimize Damage**: The participants understand that not every foreclosure can be prevented nor every home saved. All parties should work to minimize the damage to borrowers, communities, and the mortgage market when saving the home is not possible.

6. **Accountability**: A system should be developed for measuring progress on achieving the principles outlined above so that the parties can track progress, and so that the process is as transparent as possible.

Many Department licensees have already agreed to the above Principles including, but not limited to, Countrywide, Litton Loan Servicing, HSBC, and others. For those licensees that have not yet adopted these Principles, the Commissioner encourages them to adopt and comply with the Principles on an ongoing basis and to inform the Department accordingly. A special form being developed by the Department will be designed to assist in monitoring licensee compliance with these Principles as well as current laws, and will help provide a quick overview of ongoing efforts to help financially distressed borrowers receive modified loan products. Although the above-referenced Principles are designed to address certain adjustable rate mortgage loans, it is anticipated that licensees will be asked to answer questions relating to other loan types as well.

Establishing A Mortgage Loan Working Group

In addition, the Department will convene a working group by October 31, 2007, comprised of interested stakeholders from industry and consumer groups. Among other things, this group will help to advise the Department (including with regard to the special form described above), and to analyze the efficacy of assistance provided to financially stressed borrowers including, but not limited to, a more comprehensive report to measure licensee performance in providing workout arrangements.

For Further Information

Copies of the above-referenced documents, including the Principles published by the United States Senate Committee on Banking, Housing and Urban Affairs and entitled, "Homeownership Preservation Statement of Principles," the federal financial agencies' "Statement on Loss Strategies for Servicers of Residential Mortgages," and the Joint Release of FDIC, CSBS and AARMR, are all are available on the Department's web page at www.corp.ca.gov in the Education and Outreach link under the heading of Nontraditional Mortgage and Loan Information.

Should you have any questions concerning this Release, please contact the Department's Consumer Resource Center at 1-866-275-2677.

Preston DuFauchard
California Corporations Commissioner

By ______________________________

TIMOTHY L. Le BAS
Deputy Commissioner
Office of Legislation and Policy

Homeownership Preservation Summit
Statement of Principles
May 2, 2007

The goal of the Homeownership Preservation Summit is to maximize the number of homeowners who are able to stay in their homes who would otherwise be threatened with default and foreclosure as subprime hybrid ARMs reset, resulting in significant payment shocks. Participants recognize that no one – not investors, servicers, lenders, homeowners, or neighborhoods – benefits when families lose their homes to foreclosure. To preserve homeownership upon rate reset, consistent with applicable legal and contractual obligations, and accounting standards, the participants agree with the following set of principles:

1. **Early Contact and Evaluation**: Servicers should attempt to contact subprime ARM borrowers prior to the loan reset to determine whether the borrower can afford the new, higher payments, or whether the higher payments create a reasonable risk of default. If it is clear, after reviewing all the available facts and circumstances, that the borrower will be unable to make the new payment when the loan resets, then the servicer may presume that default on the mortgage is reasonably likely to occur. This conclusion may permit the servicer to modify the loan.

2. **Modify to Create Longterm Affordability**: If the borrower cannot afford the reset payment (as described above), servicers should seek to modify loans prior to the reset. The objective of the modification should be to create a permanent solution for the borrower to ensure that the loan is sustainable for the life of the loan rather than, for example, deferring the rate reset period. Such modification options should include, as appropriate, one or more of the following:

   - Change of terms. Switching from an adjustable to a fixed rate loan at an affordable rate by, for example, making the introductory rate permanent.
   - Reduce the interest rate. Reducing the interest rate is one way to assist a borrower to afford the mortgage. Ability to repay should take into account the borrower's total debt-to-income ratio, including factoring in the costs of taxes and insurance.
   - Reduce principal. Reducing the loan principal in order to ensure affordability and a continued revenue stream on the loan.
   - Reamortize the loan. Reamortizing the loan to account for any changed loan terms or to make the payments more affordable.
   - Escrows. If possible, servicers should begin to escrow for taxes and insurance as part of the modification process to ensure the home loan will remain sustainable for the life of the loan.

3. **Dedicated Teams or Resources**: Servicers should adopt a modification policy so that modifications can be done on the scale required in the time required by dedicated teams or dedicated resources. Where feasible, servicers should partner with experienced third party counselors and non-profits to make outreach as effective as possible.

4. **Low-Cost Refinancing**: For those who are eligible, refinancing to prime loans should be made in as streamlined and low-cost fashion as possible.

5. **Credit Availability**: In conjunction with lender efforts to modify or refinance existing loans, the GSEs should work with lenders to make credit available to borrowers through new products and expanded programs provided on affordable terms so that borrowers can refinance out of the resetting subprime ARMs. These new loans should be underwritten to provide long-term affordability. FHA should provide insurance for such loans when possible and desirable. The GSEs should also explore opportunities to buy subprime portfolios and modify them according to these principles.

6. **Maximize Success, Minimize Damage**: The participants understand that not every foreclosure can be prevented nor every home saved. All parties should work to minimize the damage to borrowers, communities, and the mortgage market when saving the home is not possible.

7. **Accountability**: A system should be developed for measuring progress on achieving the principles outlined above so that the parties can track progress, and so that the process is as transparent as possible.

Homeownership Preservation Summit Principles Update

As part of his efforts to preserve homeownership for millions of American families and to strengthen local communities and our nation's economy, Senator Chris Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, has announced that leading stakeholders in the subprime mortgage market have agreed to a comprehensive set of principles when working with families facing foreclosure on their homes. The principles are based on the premise that everyone – investors, servicers, lenders, homeowners, and neighborhoods – benefits when families' homes are protected from foreclosure to the extent possible.

For the full text of the principles, click **here**.

The following organizations and companies commented on the Summit and the principles that grew from it:

Mortgage Bankers Association

John M. Robbins, CMB, Chairman

"The Mortgage Bankers Association endorses the homeownership preservation principles developed under Chairman Dodd's leadership. We appreciate the Chairman's efforts in bringing together important elements of the mortgage finance industry to ensure that all that can be done on behalf of borrowers facing foreclosure is being done."

Citigroup

Carl Levinson, President and Chief Executive Officer of Citi's Consumer Lending Group

"Citi applauds Chairman Dodd's leadership in addressing the needs of families who are at risk of losing their homes to foreclosure. These are difficult times for low- and moderate-income homeowners and the industry must work together with advocacy groups and elected officials to provide needed relief now and long term solutions going forward. Recognizing this, Citi supports the Statement of Principles developed by Chairman Dodd and his Homeownership Preservation Summit and calls on other lenders to join Citi in advocating the adoption of these principles by the industry and helping homeowners remain homeowners."

JPMorgan Chase

David Lowman, CEO of Chase Home Lending

"We support Sen. Dodd's efforts to help families who are struggling with their mortgage payments. We believe we can develop the best solutions by working with the Senate committee, our regulators, borrowers, investors and community representatives."

Litton Loan Servicing

Larry B. Litton, Jr. President and CEO

"The principles that Senator Christopher Dodd and the Senate Banking Committee have developed are aligned with the homeownership preservation and loan modification practices Litton has been employing for years to help those borrowers stay in their homes. We have been actively working with the federal and local governments, community organizations, customers, investors, and regulators on this issue and we believe this is a great tool the industry can use to help reduce the number of foreclosures facing the subprime industry, while continuing to meet our obligations to our investors."

HSBC Finance Corporation

Brendan McDonagh, Chief Executive Officer

"As part of its ongoing commitment to sustaining homeownership through responsible lending and servicing, HSBC supports the guidance provided by the U.S. Senate Banking Committee's Statement of Principles announced today by Senator Dodd. HSBC has been pleased to work with Senator Dodd, the Committee and industry colleagues in discussing the important issues facing homeowners today. HSBC has been servicing customers for more than 125 years, through many credit cycles and a wide range of economic circumstances. We take the current mortgage environment seriously and we are taking strong and proactive steps to minimize the impact on our customers."

Freddie Mac

Richard F. Syron, Chairman and CEO

"We applaud Senator Dodd's leadership and support his principles to preserve homeownership.

These principles complement Freddie Mac's longstanding commitment to putting people into homes that they can afford and keep."

Fannie Mae

Daniel H. Mudd, President and CEO

"We're pleased to sign on to the statement of principles and we appreciate Senator Dodd's leadership in convening the Homeownership Preservation Summit. Fannie Mae is committed to being part of a solution that keeps people in homes, minimizes market disruption and improves practices and products for consumers."

Self-Help Credit Union

Martin Eakes, Chief Executive Officer

"I commend Senator Dodd and all the industry participants in developing improved practices. "Without intervention by every segment of the mortgage industry along these lines, hundreds of thousands of American families who have been placed in subprime mortgage loans whose interest rates are set to explode in the near future will lose their homes to foreclosure. To avoid this fate, which serves neither borrowers nor investors, servicers should take advantage of their ability to extend the initial rate for the life of the loan and make any other adjustments so that families can stay in their homes and investors can continue to get paid."

Leadership Conference on Civil Rights

Wade Henderson, Executive Director

"We support Sen. Dodd's proposal to help thousands of Americans keep their homes. "Too many have lost their homes already. The foreclosure crisis has especially devastated thousands of minorities and low-income Americans who saw their American dream – to own their own home – turn into a nightmare."

AARP

David P. Sloane, Senior Managing Director, Government Relations and Advocacy

"AARP strongly supports the principles, which will help millions of families who are at risk of losing their homes because of unconscionable practices on the part of predatory lenders. We are hopeful that Congress will act to pass strong, consumer-oriented predatory mortgage lending legislation to prevent these practices from continuing in the future."

ACORN

Maude Hurd, President

"We are proud to be a part of the efforts by Senator Dodd and the Committee to stop the massive foreclosure crisis that is ravaging our neighborhoods. ... We also applaud those mortgage companies who have agreed to the principles for homeownership preservation and thus are taking the necessary steps to help families who are facing foreclosure. For the last two years we have been advocating that when lenders modify a loan, they should make sure that it gives the homeowner long term affordability. This is a major principle, and we are glad to see that some of the largest mortgage companies have agreed to this. We call on all mortgage companies to adopt these same principles."

Countrywide Financial Corp

Sandy Samuels, Executive Managing Director

"Countrywide applauds Senator Dodd's leadership and vision in bringing together industry leaders, regulators and community groups to develop practical, workable solutions for subprime borrowers facing delinquency and foreclosure."

Wells Fargo Home Mortgage

Cara Heiden, Division President

"Wells Fargo appreciates the leadership role Chairman Dodd has taken in bringing together a diverse group of stakeholders at his recent Homeownership Preservation Summit to reach agreement on these important principles. The principles mirror Wells Fargo's long-standing affirmative fair and responsible lending practices, and reflect our commitment to finding solutions for the financial challenges some nonprime consumers are facing."

American Financial Services Association

Chris Stinebert, President and CEO

"We appreciate Senator Dodd's efforts in this area, as foreclosure is a result that neither borrowers nor lenders want. Lenders are in the business of helping people buy and keep their homes. We stand ready to work with Senator Dodd and the Senate Banking Committee as needed."

Option One Mortgage Corporation

Bob Dubrish, Chief Executive Officer

"We congratulate Senator Dodd and the Senate Banking Committee on developing the Statement of Principles for mortgage servicers. From our founding, we have understood the important responsibility that we have as mortgage servicers to families and communities. Our highest priority is serving our borrowers well."

ATE OF CALIFORNIA — BUSINESS, TRANSPORTATION AND HOUSING AGENCY ARNOLD SCHWARZENEGGER, *Governor*

EPARTMENT OF REAL ESTATE *Serving Californians Since 1917*
FFICE OF THE COMMISSIONER
01 Broadway
O. Box 187000
cramento, CA 95818
16) 227-0782

August 30, 2007

The Honorable Mike Machado, Chair
Banking, Finance and Insurance Committee
State Capitol, Room 5066
Sacramento, CA 95814

Dear Senator Machado:

Thank you for affording me the opportunity to participate in the informational hearing on Preserving the American Dream: Homeownership Preservation and the Subprime Mortgage Crisis. It is my understanding you would like clarification on what the Department of Real Estate (DRE) can do to ensure its licensees place borrowers into a loan commensurate with their qualifications, and that distressed borrowers are afforded the opportunity by lenders and loan servicers to keep their home by virtue of loan workouts, such as loan modifications or refinances.

I believe it is important for you to know what has been done to date and then to consider the additional efforts that the Department will be undertaking to address the items you referred to during the hearing. To that end, I have attached a document to this letter which encapsulates our efforts thus far and in addition, the action items that the DRE is moving forward with ("DRE Current & Proposed Efforts"). Please feel free to provide any feedback and suggestions on ways to augment or better accomplish our mutual goal of protecting consumers.

Lastly, during the hearing you requested an update of our enforcement actions for the current year to date as compared to last year. In this regard, I have attached a document entitled "Enforcement Actions Update" for your reference.

I appreciate the opportunity to provide this information, and if you would like to discuss any of the material, please contact me at 916-227-0782.

Sincerely,

JEFF DAVI
Real Estate Commissioner

JD:lrs

AUG 30 2007

DEPARTMENT OF REAL ESTATE
SUB-PRIME/NON-TRADITIONAL LOANS
CURRENT & PROPOSED FUTURE ACTIONS

EFFORTS SO FAR:

- The Spring 2007 Real Estate Bulletin contained an article reminding brokers that it is their fiduciary duty to fully explain the terms and inherent risks of option ARM's to their borrowers. Enclosed is a copy of the article for your review.

- The Summer 2007 Real Estate Bulletin contained an article explaining what it means to be a fiduciary and why it matters. Enclosed is a copy of the article for your review.

- I have written a column for the California Association of Realtors® magazine, stating it is incumbent that all agents take an active role in weeding out the bad actors and to file complaints.

- I have personally participated in the consumer Town Hall events, urging, among other things, consumers to contact their lenders if they are in financial trouble and to file a complaint if they dealt with an unscrupulous broker. I also encouraged the attendees that may be facing foreclosure or in default to contact their lender and speak with someone who can help them with a workout.

- Early this year, I instructed the Department's audit program to focus random audit activity on brokers engaging in mortgage brokering. As part of the mortgage loan brokering audit, the Department now surveys borrowers to verify, among other things, that the broker delivered and explained the loan that was initially promised.

- I have retooled the Department's ability to sift through its licensing database so those real estate brokers engaged in mortgage brokering can be more easily identified. While not precise, it has proved useful. Of the approximate 147,000 real estate brokers, it appears there are approximately 31,000 engaging in some aspect of the mortgage business.

- Since the beginning of the year, I have spoken at 28 industry events, sponsored by, among others, the California Association of Realtors® and the California Association of Mortgage Brokers. At each of these events, attendees were told they had a responsibility to help address the issues arising out of the increase in foreclosures. In total, there were over 4,000 attendees at these events. Included in this number are the two Town Halls as well as a Community Housing Conference held in Westminster, which was sponsored by Senator Tom Harman & Assembly Member Van Tran.

- This past fiscal year, the number of enforcement cases received and screened has increased by nearly 17 percent.

PROPOSED ACTIONS:

With respect to using the venerable "Bully Pulpit" to remind brokers of their duty to act in the best interest of the borrower, including their responsibility to provide a loan product that is commensurate with a borrower's qualifications, I have set in motion an intense educational effort. Among other things, the Department of Real Estate (DRE) intends to:

- Send an individualized letter to the 31,000 licensees that have been identified as mortgage brokers, outlining their responsibilities as mortgage brokers. This letter will also encourage them to adopt the best practices as set forth in the Guidance on Non-Traditional Mortgages and the Statement on Subprime Lending and remind them to encourage their lenders and the servicers of loans they broker to work out things with their borrowers who are in foreclosure or default and to provide loan modification agreements, instead of foreclosures.

- Increase the enforcement effort in all areas of mortgage brokerage, but specifically with a new "Mortgage Ads Review Program" within the MLB section of the department. There would be a focus on mortgage loan ads and actions taken to correct or ensure that the advertisements do not mislead the public or attempt to align borrowers with an inappropriate loan product. This effort will include writing to major newspapers to educate editors of ad requirements.

- Increase the visibility of license disciplinary actions taken against mortgage brokers who have mistreated borrowers through the DRE website and the Real Estate and Mortgage Loan Bulletins, which are published by the department.

In an effort to further encourage real estate licensees to work with distressed borrowers so they have a better chance of remaining in their homes and salvaging their credit, I intend to:

- Continue my efforts during my speaking engagements to mortgage brokerage trade associations to encourage mortgage brokers to assist borrowers who are in default on their loans and to work with lenders to effect workable solutions.

- Request that the California Association of Mortgage Brokers print an article from me that asks them to work with lenders and servicers to encourage them to workout instead of foreclose.

- Run an article in the Mortgage Loan Bulletin focusing on the need for lenders and servicers to work things out with borrowers and provide them with the much needed extensions and/or modifications to their loans in order to avoid foreclosure for their borrowers.

- Encourage mortgage brokers to partner with their lenders on consumer education, especially to inform borrowers of the options to foreclosure, such as short sales and loan modifications.

DRE
CALIFORNIA
Serving Californians Since 1917

REAL ESTATE BULLETIN

Arnold Schwarzenegger, Governor
Dale Bonner, Secretary, Business, Transportation, & Housing Agency
Jeff Davi, Real Estate Commissioner

http://www.dre.ca.gov

Department of Real Estate

Understanding loan terms is essential to borrowers-

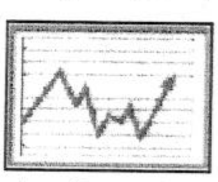
Spring 2007 Real Estate Bulletin

Buyers dreaming of homeownership often shop for loans by looking for the program that has the lowest payments. In the past several years increasing numbers of these buyers have chosen payment option adjustable rate mortgages (ARMs) to purchase a home thought unaffordable and to limit their monthly payments.

The large number of these loans that are now on the books and the gradual but steady increase in interest rates from the lows in 2003 have caught the attention of the national media, Federal Reserve and banking regulators. The concerns over rising interest rates, the slowing of the housing market and the potential financial impact of these loans on consumers is real. The payment option ARM typically allows the borrower to make payments, at their option, based on a 1% interest rate, interest only, with a 15-year or 30-year amortization but there are many variations. If these loans are marketed to buyers based on claims of low payments or housing affordability, then it can be assumed that many, if not most, buyers will choose the lowest payment option.

We have analyzed the impact on a buyer who takes a \$300,000 payment option ARM and makes the minimum payments of \$965.00 per month. The analysis is based on an actual adjustable rate note from a national lender. The note provides for first year payments based on a 1% interest rate, annual payment increases of no more than 7 ½% of the previous payment for 5 years after which full payments must be made to amortize the loan over the remaining term. Interest is adjustable monthly beginning after the first month based on the Twelve-Month Average of monthly yields on actively traded United States Treasury Securities adjusted to a constant maturity of one year as published by the Federal Reserve Statistical Release entitled "Selected Interest Rates (h-15)," otherwise known as the MTA. The margin is 3.10. Maximum deferred interest (negative amortization) is 115% of the original principal balance. There is no cap on the monthly rate increases and the life cap is 9.95%. As of the date this article was written, the index value for the Monthly Treasury Average was 4.88 making the fully indexed interest rate 8.0% after rounding. Let's assume that there are no increases in the index for the first 5 years (a very conservative and unrealistic assumption). The loan term is 360 months.

After year one the balance has increased, because of negative amortization, from the original \$300,000 to \$312,814; after year 2, \$325,787; and after year 3, \$338,861. After the 43rd month, the deferred interest maximum is met (\$345,328).



Since there have been payment increases of 7 ½% each year, the monthly payment of \$1,199.00 after year 3, would increase to \$2,604.00 per month (the fully amortizing payment over the remaining 317 months) - an increase of \$1,405.00 monthly barring any interest rate increases for the life of the loan. Considering that the one-year Treasury Security index value has increased almost 400% since January 2004, even though interest rate increases have slowed recently, the likelihood that this loan would achieve its maximum interest rate of 9.95% is very good. If that were the case after 43 months, the monthly payments would have ballooned to \$3,063, a 317% increase from the original payment of \$965.00.00 per month.

Unless the buyers have planned for the payment increases by either expected increases in income, setting aside all or part of the monthly payment differentials, or some other financial plan to meet the increased debt service, the financial impact could be severe. Couple that with the slowing of the housing market with values either leveling off or decreasing in some markets, the buyer who failed to plan could be forced into selling the home, possibly using a short sale if the loan balance exceeded the sales price, or even foreclosure. Some of these loans that closed in the last three to four years may soon be reaching their maximum allowed balances.

That is why it is incumbent upon licensees who arrange loans as mortgage brokers to completely detail the terms of these loans both in their advertising and when consulting with consumers and discussing different loan options. That includes an explanation of the rates at which interest can accrue and the effects of deferred interest. Licensees who sell these loan programs based on their benefits (i.e., low payment options), must also explain the risks involved and help borrowers determine if such a program is right for them or not. Payment option, interest only and other such ARM

loan products may not be right for everyone, especially first-time buyers and those who are trying to afford a home for which they may not otherwise qualify.

The terms of these loans are laid out in the adjustable rate note, addendums and disclosures. While it is incumbent on all buyers/borrowers to read and understand these documents, the details can be daunting. There are many variations of these loans on the market today. It is the fiduciary duty of each licensee who represents the borrower in obtaining a loan to completely explain the terms and discuss the relative merits and risks of these loan products well before the point of signing loan documents. *(Revised 4/12/2007)*

The real estate brokerage as fiduciary: *a summary review of what it means and why it matters*

by Wayne S. Bell, Chief Counsel

Summer 2007 Real Estate Bulletin

The word "fiduciary" is derived from the Latin words *fiduciarius* and *fiducia*, relating to confidence and trust. It also appears to stem from the Latin words *fides*, meaning faith, and *fidelitas*, the equivalent of loyal. While the term fiduciary is somewhat amorphous, vague and difficult to precisely determine, it is commonly applied to a person who holds a special position of confidence, trust and responsibility towards another.

It was in the realm of trusts that the legal conceptualization of fiduciary relationships arose almost 80 years ago. Justice Benjamin Cardozo opined that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the *punctilio of honor the most sensitive*, is the standard of behavior". *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928). In distinguishing "trusted persons" (fiduciaries) from the general public and the market place, Justice Cardozo determined that certain conduct that is permissible in the business world for those acting at arm's length is impermissible to those bound by fiduciary duties.

Under California law, certain "special" relationships involving a high degree of trust, fidelity, integrity and confidence, and the exercise of professional expertise or special knowledge and discretion or power, rise to the stature of a fiduciary relationship. They include a trustee and a beneficiary, a lawyer and his or her clients, a member of a board of directors and his or her corporation, and a real estate agent and his or her principals/clients. The latter includes a mortgage loan broker licensed by the Department of Real Estate and his or her borrowers.

In the real estate transactions context, by reason of the fiduciary relationship, the brokerage, acting through its designated broker officer and the responsible real estate broker associate(s) and/or salesperson(s), owes, and its agents owe, certain special fiduciary duties to its client(s). Fiduciary duties impose the highest standard of care, and real estate licensees must be committed to scrupulously fulfilling those obligations.

In the case of *George Ball Pacific, Inc. v. Coldwell Banker & Co.*, 117 Cal. App.3d 248 (1981), at page 256, the Court of Appeal (First District) noted that the general principles of agency combine with the statutory duties of the Real Estate Law to impose "on a real estate agent 'the same obligation of undivided service and loyalty that [the law] imposes on a trustee in favor of his beneficiary.' [Citations.] This relationship not only imposes [on the agent] the duty of acting in the highest good faith toward his principal but precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency. [Citation.]" A real estate licensee is further "charged with the duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision. [Citations]".

With regard to the duty of full and truthful disclosure as it relates to a property, a real estate agent has an affirmative obligation to disclose to his or her client all material facts which are and reasonably should be known affecting the value and/or desirability of the property. In addition, the duty of full disclosure would require that an agent present all offers and counteroffers in a timely and diligent manner, unless his or her client has previously directed the agent to do otherwise. Providing a client with all of the available information permits the client to make an informed and intelligent decision in his or her best interest. Real estate licensees must also disclose the nature and full amount of any compensation, commission, or profit that they receive or will receive from the transaction.

In addition to those duties of undivided loyalty, good faith and full disclosure identified in the *Coldwell Banker* decision, California law imposes the following fiduciary duties on real estate licensees:

- To diligently exercise reasonable care, diligence and skill in representing a client and in the performance of the responsibilities of the agency relationship. By reason of his or her licensure, a real estate agent is deemed to have specialized and professional expertise, knowledge and skill in real estate related matters superior to that of the average

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person. The nature of the fiduciary relationship is such as to cause the client to justifiably rely on the licensee/agent.

- To fully account in a timely manner for all funds and property received in which the client has or may have an interest. This duty requires an agent to safeguard any money, deeds, and other documents entrusted to the agent that are related to his or her client.
- To not disclose confidential information of or about the client, including the client's business, financial or business affairs, unless authorized to do so. This duty mandates that an agent must keep confidential any information that might weaken or undermine his or her client's position if the same were revealed.
- To exercise the utmost honesty, absolute candor, integrity and unselfishness toward the client. This requires that an agent not compete with his or her client and act at all times in the best interests of his or her client to the exclusion of all other interests, including interests that could benefit the agent or others. In addition, this requires that a licensee refrain from dual representation in a real estate sales transaction unless he or she obtains the consent of both principals after full disclosure.
- To obediently, efficiently and promptly follow the lawful instructions of his or her client.

While fiduciary duties have been imposed over the years through the common law, which is the extensive non-statutory body of law reflecting general legal principles and Court-made case law and precedent, they can also be undertaken by agreement and imposed by statutory and regulatory law. But the California statutory and regulatory scheme does not restrict the broader fiduciary duties owed by licensees existing under the common law. See, for example, the Legislature's statement of its intention in adopting the legislation which became Section 2079 of the California Civil Code, which section is titled "Real estate brokers and salespersons; inspections and disclosures; standards of professional conduct".

Breaches of Fiduciary Duties and Remedies

The following discussion is not intended to be an exhaustive discussion of all the remedies available for the breach(es) of fiduciary duties, or an analysis of the distinctions and boundaries between the common law and statutory and regulatory law, legal and equitable remedies and/or contract and tort law. Rather, the purpose of the discussion is to familiarize real estate licensees with the general range and variety of remedies available.

When a client feels wronged by his or her real estate brokerage and agent, the client oft-times files a lawsuit seeking damages and other remedies on theories ranging from breach of contract, intentional misrepresentation, negligent misrepresentation, and various others. It is the nature of the breach, the wrong and the loss (or the harm suffered) that will determine the scope and the applicability of remedies. In an action for an alleged breach of fiduciary duty(ies), a presumption of unfairness and undue influence arises when a fiduciary self-deals or gains an advantage in a transaction.

Depending on the facts of a particular case, a client suing for breach(es) of fiduciary duties can recover a full range of damages, including actual as well as punitive and exemplary damages. Moreover, when a client is defrauded by a fiduciary, the client is entitled to the benefit of his or her bargain and is awarded compensation for all of the detriment proximately caused by the breach, whether it could be anticipated or not. See §§§ 1709, 3333 and 3343 of the California Civil Code. Also, a real estate agent who breaches his or her fiduciary obligations may forfeit and be deprived of his or her commission. *Sierra Pacific Industries v. Carter*, 104 Cal.App.3d 579 (1980), at page 583.

In appropriate cases, such as where there is no adequate legal remedy capable of providing a client with a complete measure of justice, or where necessary to prevent irreparable injury, the client may obtain equitable relief, including an account of profits, the disgorgement of "secret" profits, the imposition of a constructive trust, the grant of an equitable lien, the setting aside, rescission or voiding of unconscionable transactions, and the delivery and/or cancellation of documents. When applying equitable remedies, the Courts endeavor to shape and design a judgment to provide substantial justice to the client who has been wronged and has suffered harm by the breach(es).

Administrative Discipline Because of Breach(es) of Codified Fiduciary Duties

As mentioned above, fiduciary duties can be imposed by statutory and regulatory law. Some of the fiduciary duties that arose through common law principles have been codified in certain of the California statutes and regulations that are enforced by the Department of Real Estate. For example, the duty to fully account for client funds is reflected in §10176 (e) of the California Business and Professions Code prohibiting the commingling of trust funds belonging to a client with the funds of a broker, and Real Estate Commissioner's Regulation 2831.1, which pertains to the requirement that agents must adequately separate trust fund beneficiary records. Similarly, the duties that preclude an agent from obtaining any advantage over the principal by virtue of the agency, and that require that an agent act in his or her client's best interests are incorporated into §§ 10176 (g) and 10176 (i) of the Business and Professions Code, dealing with secret profits or undisclosed compensation, and fraud or dishonest dealing in a licensed capacity, respectively. There are more examples of such statutory and regulatory codification, but a further discussion of the same is beyond the scope of this article.

Violations of the statutes and regulations enforced by the Department of Real Estate form the basis for administrative discipline against the offending real estate licensees. For a violation of one or more of such statutes and/or regulations, a licensee can have his or her license revoked or suspended.

What Does This Mean in Practical Terms?

California real estate agents, as fiduciaries, owe special duties to their clients. Agents must be continuously aware of their important fiduciary duties and must perform them responsibly, diligently and completely. If they fail to do so, they risk significant civil liability and remedies, in addition to administrative discipline where their misconduct also violated the statutes and/or regulations enforced by the Department of Real Estate.

UPDATE OF DISCIPLINARY ACTIONS INVOLVING MORTGAGE LOAN TRANSACTIONS

FY 05/06	149 Disciplinary Actions
FY 06/07	165 Disciplinary Actions
FY 07/08	Project 15% increase

Breakdown of FY 05/06 & 06/07 Disciplinary Actions:

Revocations:	53
Revocations/Restricted License:	50
Surrendered:	31
Suspended:	159
Public Reproval:	21

In addition, 30 Desist and Refrain Orders were issued.